3rd SWISS ENTERPRISE TAX REFORM:

TURNING TROUBLES INTO A COMPETITIVE ADVANTAGE?

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3^{rd} Swiss Enterprise Tax Reform

- The troubles
- Positive results
- The federal proposals
- The cantonal proposals
- The bad news …
- Discussion
- Annex: state aid and harmful tax competition

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The troubles:
EC-Swiss cantonal tax dispute

- EC-CH tax dispute on **cantonal corporate taxation** since 2005
- EU claims that the Swiss cantonal tax privileges constitute **forbidden state aid** (based on FTA 1972)
- Since 2010 “dialogue” also addresses **Code of Conduct** (ECOFIN 1997)
- Agreement to abolish criticized cantonal regimes signed between the EU and Switzerland on July 1, 2014

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Positive results from the troubles

- **Parliament** proposed (i) a proper **participation exemption**, (ii) an **interest box** / group financing regime and (iii) an IP / **licensing box**
- Corporate income tax could be reduced to **12 to 14%**
- Reduction or abolition of **stamp duties and corporate net wealth tax**
- Cantonal tax regimes becoming **Eurocompatible** (NE, NW)
- **NE** Overall effective tax rate of approx. 22.2% in 2011 reduced to approx. 15.6% by 2016. Further reductions?
- **NW** introduced a license box whereby the cantonal corporate income tax rate on net license income is reduced by 80% to an overall effective rate of only 8.8% (incl. federal tax)

Federal tax proposals Sept 2014

CORPORATE TAX:

- Participation exemption
- Notional interest deduction (NID)
- Exit tax and entry step-up
- Unlimited loss carry forward
- Tax grouping for losses
- Stamp tax reform
- ~~Special R&D incentives~~
- ~~Tonnage tax~~

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Federal tax proposals Sept 2014

INDIVIDUAL TAX:

- Capital gains tax
- Exit tax (no entry step-up?)

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Participation exemption

- An extremely generous participation exemption is proposed (complicated participation reduction rules and criticized holding regime abolished)
- **All income and capital gains from participations exempt**
- Participation: 1 share suffices (currently ≥10%/1MCHF) !
- Except for (i) payments that are deductible in the hands of the debtor (e.g. hybrid interest) and (ii) in the case of banks, for capital gains on circulating assets
- Most generous participation exemption ever seen on-shore

My vote

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Notional interest deduction (NID)

- **NID "light"**: reasonable interest deduction only on security capital/excessive equity, i.e. the equity in excess of what is necessary for the commercial activities in the long term.
- **Base** to be determined as function of risks associated with each category of assets. The current safe harbor thin cap rules of the Swiss FTA could be a starting point, plus 25%.
- **Rate** based on 10 year return on Swiss Confederation bonds (approx. 0.54%, Nov. 14) + 50 basis points and at least 2%.

Notional interest deduction (NID)

- What about financing in **functional currency**? Published interest rates of the Swiss FTA ? Return on EUR or USD bonds? German Bond 10 year yield = 0.82% (Nov. 14) US 10-Year Bond Yield = 2.354% (Nov. 14)
- **ETR on group financing** can be 9 to 15% if income does not exceed 5%, if 100% equity is applied and 85% is considered excessive and general rate is 15 to 25%.
- **Rather expensive** for group financing companies or branches compared to current situation and in international comparison

My vote

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Exit tax and entry step-up

- **End of tax liability**: all untaxed hidden reserves, including gains on intangibles created by the company, must be taxed.
- **Exit tax**: applies in case of transfer of assets or functions abroad, creation of a foreign permanent establishment (PE), liquidation, exemption and the transfer abroad of the seat or of the effective management of the company.
- **Step-up**: similar hidden reserves upon entry into Switzerland are not taxable provided they are registered in the tax accounts. Such reserves must be amortized over a 10 year period in a straight-line. Resulting losses cannot be carried forward.

Exit tax and entry step-up

- Nice on entry, terrible on exit. Difficult in application. Impediment to free establishment of business, lack of flexibility

- Step up 

- Exit tax 

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Unlimited loss carry forward

- Losses can be carried forward **indefinitely** for tax purposes (currently limited to 7 years)
- Maximum loss carry forward to be applied in a tax year becomes 80% (i.e., at least 20% of the current year profit, if any, will be taxable)
- Applicable to both corporates and individual enterprises

My vote 

Tax grouping for losses

- A Swiss parent company may deduct losses from (i) Swiss and (ii) foreign subsidiaries from its own taxable income
- Threshold: majority of votes or otherwise effective and exclusive control by the parent over the subsidiary
- Only in case subsidiary (or other group company) could not (and can no longer) take such losses into account for its own taxable income
- Loss deduction for parent based on % participation
- Losses of foreign subsidiaries must be determined on the basis of Swiss corporate income tax law

My vote ?!

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Stamp tax reform

- **Good news**: stamp issuance tax to be abolished altogether

- **Missed opportunity**: securities transfer tax to be maintained

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Cantonal tax proposals

CORPORATE TAX, SAME AS FEDERAL:

- Participation exemption
- Notional interest deduction (NID)
- Exit tax and entry step-up
- Unlimited loss carry forward
- Tax grouping for losses

CORPORATE TAX, <u>CANTONAL ONLY</u>:

- PATENT BOX (≠ LICENSE BOX)

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Cantonal tax proposals

INDIVIDUAL TAX, SAME AS FEDERAL:

- Capital gains tax
- Exit tax (entry step-up?)

Cantonal patent box

- Income from patents can benefit from a reduction of up to maximum 80%
- Corporate taxpayer needs to (i) (economically) own the patent and (ii) have made a crucial contribution to the development of the underlying invention (creation and continuous development)
- In group context: control/oversight or crucial contribution by group company in case of usufruct or exclusive license

Cantonal patent box

Also applies to:

- Supplementary Protection Certificates (SPC)
- Exclusive licenses
- Protection of first applicant (Swiss pharma)

Cantonal patent box

Qualifying patent income =

Overall income of the company less:

- financial income
- production, trading and services income insofar as not related to an eligible patent
- an amount relating to routine functions and all income from brands, trademarks

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Cantonal patent box

- Not a license box, limited to income from patents → **PATENT BOX**
- 80% only on cantonal level (ETR 9 to 12%)
- Strict conditions
- International comparison?
- State Aid / Harmful Tax Competition?

My vote

International comparison

- Royalty boxes exist among others in BE, NL, LU and UK (IT?)
- BE: patent deduction of **80%**, both for generated and acquired patents, but not for other kinds of IP - **ETR 6.8%**
- NL: innovation box with a **5% ETR** for royalty income on patents and specific approved R&D projects
  – does not apply to other intellectual property, restricted to patents linked with R&D activities in the Netherlands
- LU: 80% exemption for income from and capital gains realized with IP (larger definition than NL and BE) - **ETR 6%**
- UK (since 2013): patent box with a **10% ETR**

State Aid?

Analysis of royalty box regimes:

- Patent box not considered State Aid if it forms an integral part of the general tax system and is not selective but accessible to all enterprises (in terms of conditions, restrictions, etc.)
- But … beware of discretionary and/or standardized rulings
- Not a harmful tax regime if no distinction is made based on source (e.g. domestic or foreign source, from related companies or from third parties)
- Even if it were State Aid, it could still be a justified regime if and to the extent it promotes the investment in innovation and R&D

Future?

- **OECD BEPS Action Plan of 19 July 2013:**
  - focusing a/o on transfer pricing in general
  - on transactions with IP specifically
  - relating to the digital economy particularly
  - raising questions about substance and transparency
  - implications for IP boxes?
  → *risks/chances for the BeNeLux, Ireland and Switzerland*
- **Germany** called for the abolition of IP boxes in the EU
- **EU Commission** investigating **LU** IP boxes – requested rulings - dispute taken to ECJ – **Lux Tax Leaks**
- **IP boxes without R&D or innovation at risk**

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Special transitory provision (cantonal)

- Step-up upon abolition of special cantonal status (holding, auxiliary, mixed, base company, etc.)
- Same as step-up upon immigration: determine goodwill/ hidden reserves at transition, capitalize in fiscal balance sheet *(new concept in Swiss law!)* and amortize over ten years
- Would result in smooth transition between current privileged tax status and ordinary tax status (with high rates)
- Not needed/desired in Geneva?
- Step up for principal companies at federal level?

Bad news: somebody (else) has to pay for it …

Individuals will have to pay for the reform:

- **<u>Dividend income</u>** taxable for 70% in all cases
  (currently 50% for commercial participations ≥10%,
  60% for private participations ≥10% and
  100% for all other dividends)
- **<u>Capital gains</u>** on shares taxable for 70%
  (currently exempt, except for (i) commercial participations ≥10% (50% base), (ii) indirect partial liquidation, (iii) transposition and (iv) securities dealer/professional income)
- **<u>Capital gains</u>** on other securities taxable for 100%
  (currently exempt if private assets)

Bad news: somebody (else) has to pay for it … (2)

Individuals will have to pay for the reform:

- **Capital losses** deductible from taxable capital gains for 70, resp. 100%
- Implies introduction of separate capital "box"
- **EXIT TAX 1** Capital gains on shares: emigration or liquidation = deemed taxable disposal
- **EXIT TAX 2** Capital gains on the securities: emigration = deemed taxable disposal

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Bad news: somebody (else) has to pay for it … (3)

My observations:

- Capital gains tax as such not a bad idea. Taxation based on "capacity to contribute". Exists e.g. in the US and UK at reduced rates for long term capital gains.
- Should not exist next to an annual net wealth tax (1% in GVA). Net wealth would otherwise becomes taxable 3 times: for its income, for capital gains and for the total amount (or 4 times in case of shares held in a Swiss company)
- Net wealth tax must be abolished or a credit for the income and capital gains tax on the net wealth must be granted (already exists for corporate taxpayers since ….)

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Bad news: somebody (else) has to pay for it … (4)

My observations:

- Exit tax understandable within the context of the proposal
- But: no step-up upon immigration provided?
- Complicated in an international context, infringement on free movement and double tax treaties will need to be adjusted
- Introduction may result in massive exit before entry-into-force
- Problematic in the context of possible abolition of lump-sum taxation (November 30, 2014) and possible introduction of 20% federal gift and inheritance tax (referendum in 2015?)

Discussion

- Replacing **special regimes** by **special regimes** …
- **Difficult sell**: a <u>corporate</u> tax reform (partially) paid by <u>individuals</u>? Companies don’t vote, but individuals do …
- **State Aid**, Harmful Tax Competition, OECD **BEPS**
- **Public opinion** (Google, Amazon, Starbucks), Lux Tax Leaks
- **No real solutions** for trading, principal companies and group financing and particularly not for IP management
- **Rate reductions** can lead to long-term success (Ireland 12.5%)
- Trendsetter Neuchâtel and early minority Geneva & Vaud show the way forward with **flat, low rates** for everyone !

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Any questions ?

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Annex
Fiscal State Aid (EU)
and
Harmful Tax Competition (EU)

Definition of State Aid (in the EU)

Commission Notice on the application of the State aid rules to measures relating to direct business taxation *(OJ C 384 , 10/12/1998 P 3–9) :*

'any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market`.

Definition of State Aid (cont'd 1)

To be termed [State] aid, a measure must meet four cumulative criteria :

1. The measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, including:
   - a reduction in the tax base
   - a total or partial reduction in the amount of tax
   - deferment, cancellation or even special rescheduling of tax debt.
2. The advantage must be granted by the State or through State resources. A loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in the Member States.
3. The measure must affect competition and trade between Member States. This criterion presupposes that the beneficiary of the measure exercises an economic activity, regardless of the beneficiary's legal status or means of financing.
4. The measure must be specific or selective in that it favours 'certain undertakings or the production of certain goods`.

Definition of State Aid (cont’d 2)

Analysis of the four criteria :

Criterion 1 - Is a tax advantage granted ?

Criterion 2 - Is it granted by the State or through State resources ?

Criterion 3 - Does it affect / distort competetion and trade between the EU and Switzerland ?

Criterion 4 – Is the measure specific or selective ?
Further analysis →

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Definition of State Aid (cont'd 3)

"The selective advantage involved here may derive from an exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice on the part of the tax authorities. However, the selective nature of a measure may be justified by 'the nature or general scheme of the system`.
If so, the measure is not considered to be aid …"

(Commission notice on the application of the State aid rules to measures relating to direct business taxation (98/C 384/03))

Harmful Tax Competition (in the EU)

The 1997 ECOFIN Code of Conduct for business taxation considers the following tax measures to be potentially harmful :

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
- lack of transparency