New Swiss corporate tax developments : *A paradigm shift?*

The Report of the Joint Steering Comittee (Federal Department of Finance and the Council of Cantonal Finance Ministers)

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Agenda

I. **History**

II. **Swiss tax statuses at stake**

- **Holding, Participation Reduction, Base, Principal, Federal tax holiday, Finance Branch**

III. **Swiss response**

– **IP Box, notional interest deduction, reduction of cantonal tax rate**

IV. **The (long) way forward**

I. History (1)

- Swiss tax attractiveness based on cantonal and federal corporate tax statuses (« special tax statuses »)
  - domicile / mixed (base/auxiliary), holding, finance branch, participation reduction, principal, tax holiday based on the new regional policy
- The special tax statuses are challenged by the EU, the G20 and the OECD
  - no longer in line with international standards (e.g. ring fencing- transparency – non respect of arm's length principle)
  - state aid according to the EU
- First proposals made by the Swiss Government to the EU in 2008
- On May 29, 2013, new negotiations with the EU
  - ⇨ Possible adaptation of Swiss special tax statuses were mentionned subject to fair treatment from EU members (no counter-measures, discrimination, etc.)
- Towards the end of 2013, Switzerland announced that the 5 special tax statuses could be cancelled subject to fair treatment from EU members.
- EU aknowledged the significant progresses made by Switzerland, but EU members issued reservations concerning counter-measures

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I. History (2)

- Swiss proposal of changes should be made until the end of June 2014 (The first deadline was June 2013)

- New measures should be in line with EU and OCDE standards, in particular BEPS (base erosion and profit shifting)

- The Swiss Government is keen on reaching an agreement with the EU as long as this is mutually acceptable and enforceable (no countermeasure from EU member states)

- Situation is quite complex to handle due to the current evolving tax landscape
  - e.g. certain features of the IP box are challenged by the OECD and the EU

II. The special tax statuses at stake

The following tax statuses are challenged by the EU and the OECD:

- Holding company
- Participation reduction
- Base (mixed or domiciliary) company
- Principal company (federal level)
- Tax holiday based on the new regional policy (federal level)
- Finance branch

Please note that branches may also benefit from some of these statuses.

A. Holding Company

Definition:

- 2/3 of assets or income is derived from long term participations (fair market value).
- No commercial activity, mainly management of financial investments
- No profit taxation at cantonal and communal level (except for net income of real estate property)
- Moderate profit taxation at federal level: 7,8 % (effective tax rate) and participation reduction
- Debt financing at most 70 %
- Moderate equity tax

What is challenged by the EU or the OECD? Non imposition at cantonal level?

B. Participation reduction

- Commercial and industrial corporations holding investments (at least 10%) - or - fair market value of at least CHF 1 millions) in the capital of other corporations
- Participation reduction on income from participating interests (active or passive)
- Reduction of corporate income tax in proportion to the ratio between net earnings on such participations income and total net profit *(this aspect is challenged by the EU)*
- Same rule applies for capital gains from participations of at least 10% held during min. 1 year

C. Base Company in Vaud (Mixed and / or Domiciliary)

Definition :

- Company whose activity is mainly carried out abroad
- Low profit tax rate for foreign income only *(This is specifically challenged by the EU)*
- Higher rates if owned by Swiss residents
- Swiss sourced income taxed ordinarily

Conditions :

- focus on foreign markets (foreign dependency)
- 85% of income and connected expenses from foreign sources (sales, trading, finance, intellectual property rights and other services)

Profit effective rate :

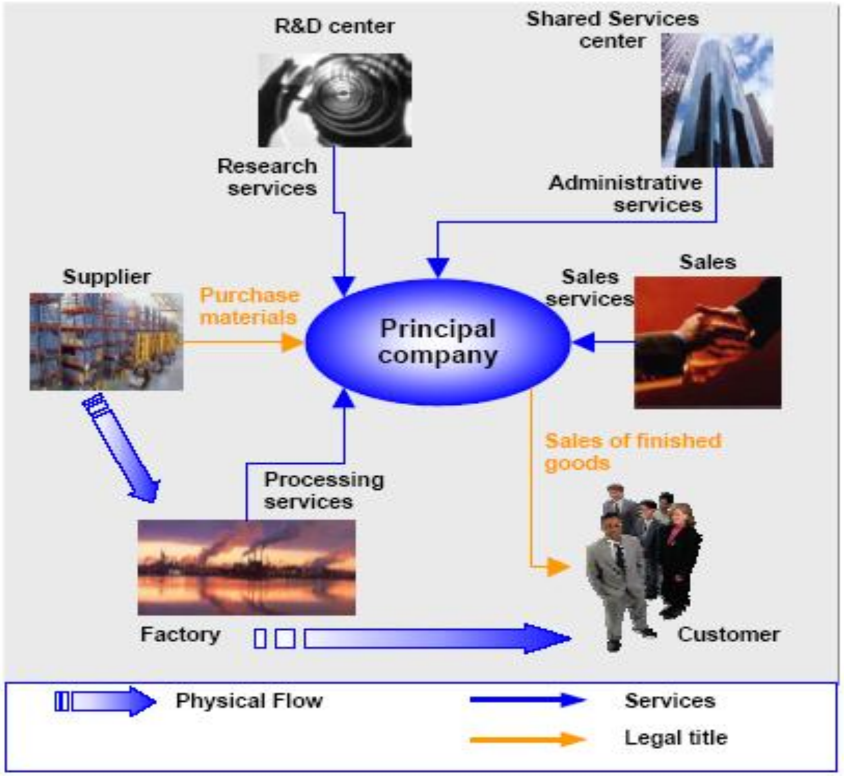
- 9 to 14% (cantonal, communal and federal level)

D. Principal Company : conditions (1)

- **The Principal company** in Switzerland (the Principal) takes responsibility of the following tasks for its global market : purchases, R&D planning, production and distribution planning, stock management, logistic planning, marketing strategy, development, sales, treasury, etc.
- **Production** is carried out by affiliated or third parties acting for the account of the Principal (Contract Manufacturers) and remunerated on a cost-plus basis.
- **Distribution (sale)** is made by subsidiaries (commissionaire) acting on their own name but for the account of the Principal and remunerated on a commission basis. Stocks, debtor and exchange risks are borne by the Principal. LRD distributors do also qualify if the allocation of risks is similar.

D. Principal company: supply chain Management (2)

- The Swiss principal tax status meets all the most modern supply chain management's requirements.
- Full fledged Share Services Center



Source: Global Logistics & Supply Chain Strategies, *Building a Tax-Effective Supply Chain*, November 1998

D. Principal company: International allocation of income at federal level (3)

	Federal profit tax
▪ SPC sells goods via subsidiaries acting in their own name but for the account of SPC (dependent agents according to Art. 5 par. 5 OECD Model Convention)	➢ Financial income + non-production and non commercial income (e.g. royalties and commissions) are fully taxed. The Principal regime applies to commercial and production net income according to the following profit-split rules : ➢ 30% of commercial and production net income is allocated to production and 70% to trade ➢ 50% of the net trade income is allocated to Switzerland
▪ Challlenged by the EU because of - lack of transparency - non respect of arm's length principle	➢ 35% of commercial and production income is then not taxable in Switzerland Resulting profit tax rate ranging from 6.1% to 8.5% at cantonal and federal level if base company status applicable

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E. New Regional Policy Federal tax holiday (1)

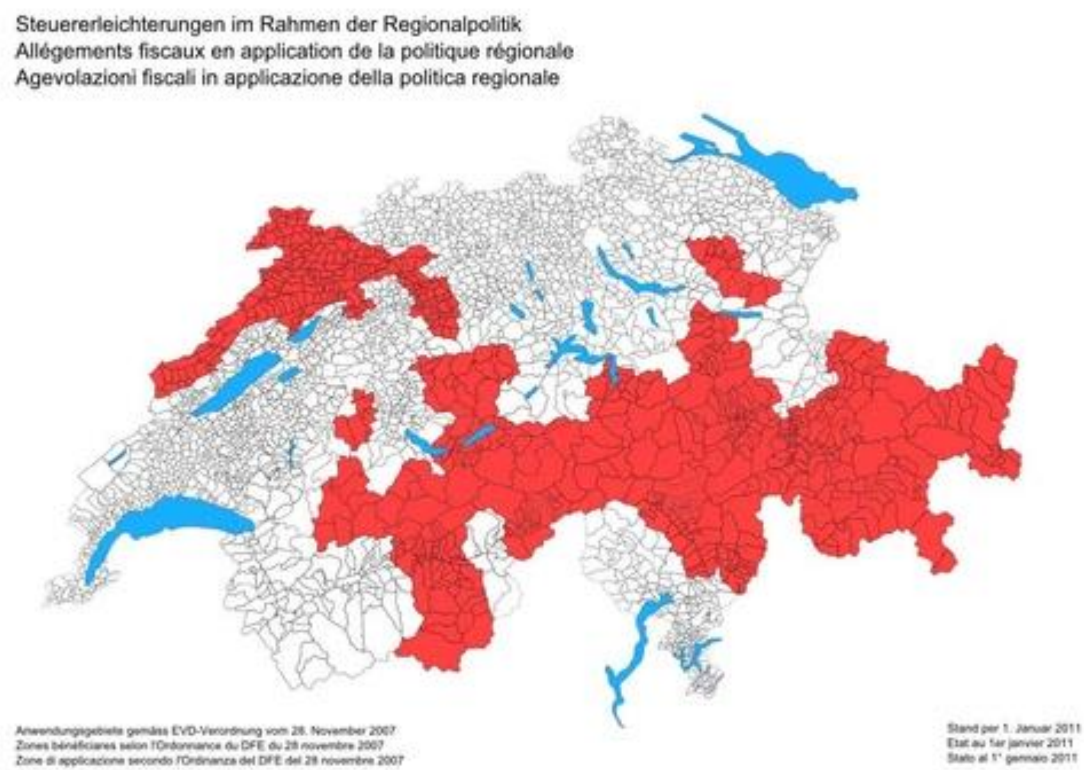
- Tax holiday granted
  - To industrial companies or companies providing services close to production
  - New jobs (creation or maintenance)
  - on federal income tax
  - full or partial
  - up to ten calendar years from the foundation or the restructuring of the business (new investments)
  - federal tax holiday may not exceed the cantonal tax holiday as to its modalities, importance and duration

- Area
  - location (see map hereafter) – this aspect is specifically challenged by the EU

E. New Regional Policy Federal tax holiday (2)

Areas qualifying for NPR incentive

- Qualifying areas has just been revised (as of January 1, 2011)
- Locations close to Lakes Geneva and Zurich have been removed



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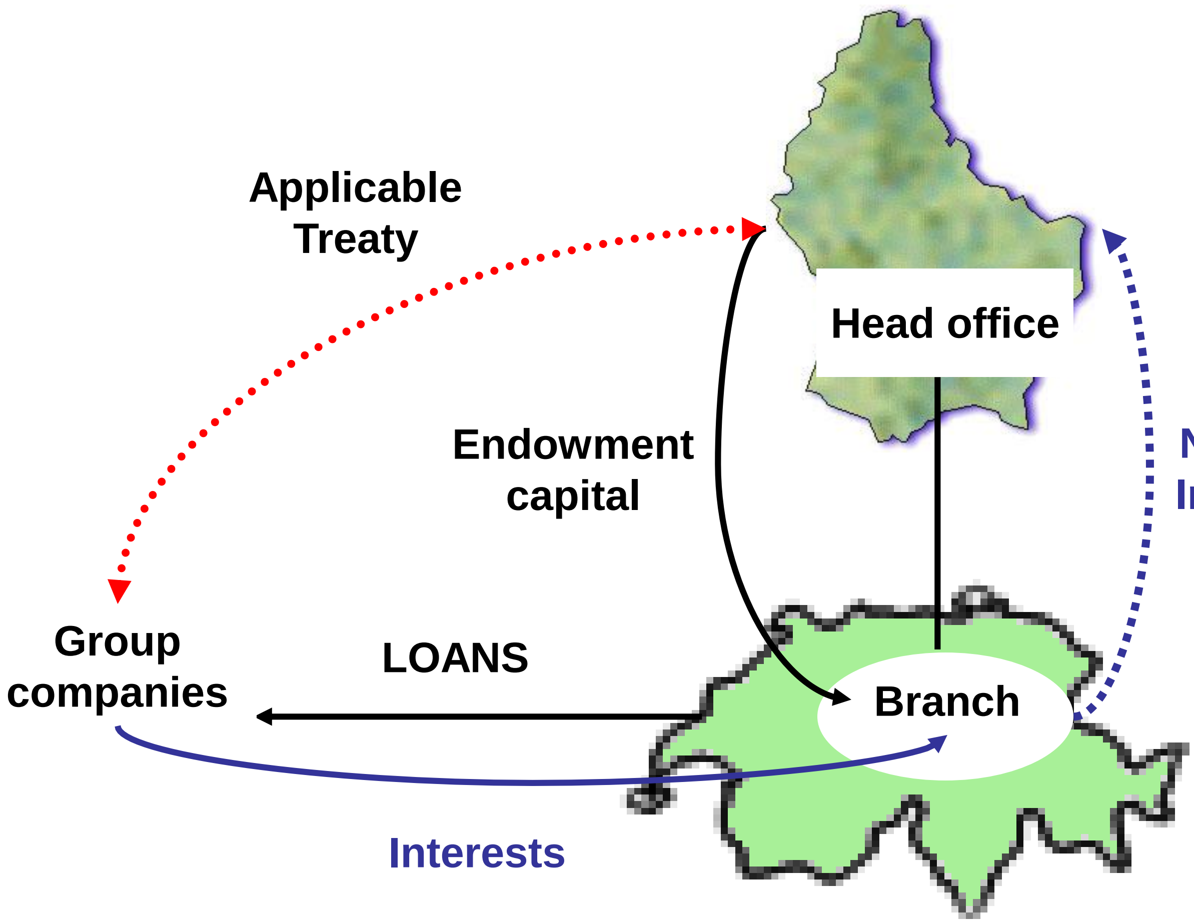
F. Swiss Finance Branch (1)



Head office location:

Luxembourg, Belgium, etc.

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F. Swiss Finance Branch in Vaud (2)
Requirements and effective direct tax rate

- Substance at head office
- Financial assets > CHF 100 million *(specifically challenged by the EU)*
- Min 75% of assets related to financial activities
- Min. 75% of revenues from financial activities
- Max. 25% of assets and revenues from non-financial activities
- Loans to Swiss subsidiaries of the group = max. 10% of assets
  (Base Company specifically challenged by the EU)
- Taxable equity : 4/100 at the cantonal level of BS without the “conduit” activity
- Notional interest deduction computed on 10/11 (96/100 at the cantonal level)
- Conduit activity
  - Spread percentage (0.25% / 0.125% / 0.0625%) as minimum taxable margin
  - Spread exceeding these percentages : tax exempt

  Notional interest deduction computed on 10/11 (96/100 at the cantonal level)

Usual effective profit tax rate : 1% to 2% in Vaud if funded by the head office

F. Swiss Finance Branch (3)
Authorized activities

- Activities of financial type (to affiliates or independent third parties)
- Services aimed at generating interests income in the broad sense and avoiding or reducing exchange risks and doubtful accounts
  - Granting of loans, including : operations aimed at covering exchange risks
  - Cash management, all treasury management for its own account or for the account of debtors and creditors in the name and for the account of group companies
  - Factoring, leasing, netting and re-invoicing to the extent that these two latter functions serve only to limit and centralize exchange risks within the group

- Activities of non-financial type (max. 25%)
  - Trade and production activities
  - Administrative services
  - Insurance activities
  - Publicity
  - Sale promotion
  - Participations maintenance
  - Profit-earnings management of fixed assets

F. Swiss Finance Branch (3)
(Example at federal level)

Assumption Balance sheet total: 550 mio. Branch profit before interest deduction: 41.25 mio.	CHF
Funds from headoffice	450 mio.
Funds from group companies and third parties (rate 8%)	100 mio.
Balance sheet total	550 mio.
Max. possible interest expense (41.25 x 10 x 1) / (11 x 1.1)	34.091 mio.
Less already paid interest	(-8 mio.)
Possible interest deduction in favour of headoffice	26.091 mio.
Taxable profit of the branch (41.25 mio. less 34.091 mio.)	7.159 mio.

III. Swiss Response (1)

The Swiss government wants

a) To maintain the current attractiveness of Switzerland.

b) To obtain certain international acceptance of the new tax measures even though uncertainty does prevail in this area.

c) Sufficient financial resources (CHF 3 to 5 billions of federal profit taxes are at stake!).

Steps (made)

1. A joint steering committee (Federal Department of Finance and the Council of Cantonal Finance Ministers) has issued and **INTERIM REPORT** in May 2013.

2. The **INTERIM REPORT** was submitted to the Swiss Government who has requested the issuance of Final report by the Federal Department of Finance.

3. **FINAL REPORT** issued in December 2013 after

   - consultation with cantons and business circles

   - issuance of OECD/G20 reports

III. Swiss Response (2)

Starting point

Certain tax statuses must be amended as long as an agreement can be reached in the course of a dialogue with the EU & and the OECD

I. Introduction of new tax measures :

a) Goal : maintaining and attracting business activities with high level mobility

b) Measures : 1. Patent / license box

2. Deduction of notional interests

3. Improvement of the participation reduction's mechanism

II. Reduction of cantonal profit tax rates

Confederation may help by increasing the amount which is currently allocated to the canton : 17% of the federal profit tax

III. Other tax measures

- Abolition of issuance stamp duty on equity
- Improvement of intra-group financing (withholding tax measure)
- Abolition of the annual cantonal tax on equity
- Deduction of R&D costs
- New federal tax holiday

III. Swiss Response (3)

What are the acceptable profit tax rates in an international context?

R&D&I and Design:	**Fee, royalty, know how, goodwill** **IP Holding, IP box, notional interest deduction, R&D tax credit, international allocation** **Acceptable rate (5-8%)**
Purchase:	**Commission, spread** **Trading status** **Acceptable rate (12%)**
Warehousing, manufacturing, marketing, distribution, after sales :	**Cost plus, commission, fee** **Service company** **Tax basis is often more important than tax rates**
Sales of goods :	**Sales** **Trading status, international allocation, notional interest deduction.** **Acceptable rate (12%)**
Finance / Investment :	**Interest, dividend finance company, holding status.** **Hybrid loan, notional interest deduction, participation exemption, interest box** **Acceptable rates: dividend 0%, interests 2-3%**

A. IP Box

- Specific tax treatment of income derived from intellectual property
- Way of assessing the tax basis and / or tax rate
- Purposes :
  - Attracting taxable income in the specific jurisdiction
  - Attracting R&D&I activities

What are the parameters?

- Typology of IP rights
- Scope of IP activities carried out by the corporate entity
- Ways of assessing the IP income
- Allocation of competences between Canton and Confederation

A. IP Box (2)
(IP eligible)

- **Importance of art. 12 II OECD model convention**
  - Copyrights
  - Patents
  - Trademarks
  - Knowhow

  What is the choice of Switzerland?

- **Ownership – license**

  ⇨ License qualifies as well if added value created by the Swiss entity

A. IP Box (3)
(Other conditions)

Scope of activities:

- Should the entity have R&D&I in Switzerland: No
- However, the entity should demonstrate substance

Substance:

- Certain key functions are carried out from Switzerland with a local staff
- Risk borne by the Swiss entity
- Significant part of income derived from R&D&I

A. IP Box (3)
(Computation)

Embedded royalties

⇨ In case, royalties are incorporated in goods which are sold: this is important for trading and principal companies

Ways of allocating the income between

- Income taxed normally (trading)
- IP privileged income

Direct allocation (transfer pricing study)

- complexity if the number of IP items is high (200 patents for instance!)

Indirect allocation

- less complicated but may wrongly allocate more income to the privileged taxation
- first determination of income not privileged based on a transfer pricing analysis

A. IP Box (4)

What type of profit tax is concerned ?

- Only cantonal
- So that federal tax is normally levied at 7.83% (effective rate if no cantonal tax is levied)
- Taxable basis assessed by the cantons as well as the level of the incentive
- The Confederation will just describe an overall framework in the tax harmonisation act (like this is the case right now for the base and holding status)
- Capital gains on IP assets also eligible
- Corporation and partnerships may take advantage of the IP box

Transitory rules:

- Systematic realization

B. Notional interest (1)

- Interests on loans are deductible from the taxable profit
- Dividends on equity are not (taken from reserves, retained earnings, etc.).
- Therefore, this creates a discrepancy as financing an activity via loans or equity are not treated in the same way
- Applicable to corporation and partnership as well as branch of foreign legal entities
- Steering comittee considers that such a deduction is applicable only if the equity exceeds the Swiss generally accepted rules in terms of capitalization (thin capitalization rules)

  - Regular equity: Application of the Swiss thin capitalization rules

  - Safe equity: based on what exceeds the Swiss thin capitalization rules

B. Notional interest (2)
Thin capitalization rules

- Art. 29a Tax Harmonisation Law: Taxable equity is increased by debts having the economic value of equity
- Guideline on interest rates and maximum debt financing for different types of assets (based on fair market value), e.g.:
  - Cash 100 %
  - Receivables 85 %
  - Loans 85 %
  - Participations 70 %
  - Intangibles 70 %
  - Tangible assets 50 %
- Max. debt financing for finance companies: 6/7 of balance sheet total
- Excess debt financing by connected parties or guaranteed by connected parties is taxable capital, unless availability of equal third party financing is proved
- Excess interest payments increase taxable profit -> contributions (35 % wht)
- No offset against losses (“share capital“)

B. Notional interest (3)
Disregarded items

The following items are disregarded when computing the notional interests:

- Investments as long they benefit from the participation reduction
- Real estates or assets allocated to foreign branches
- Assets which are not necessary for running the business activity
- Corrective measures for losses and changes in the equity during the year

B. Notional interest (4)
Interest rate

- **Interest rate on notional interest**
  - long term bond (10 years) issued by the confederation plus 50 bpts or
  - average yield on bonds of Swiss industrial companies

  should be regularly adapted

- **Notional interest on conduit activities: unclear how this computed!**

- **Following example shows how the notional interest deduction is computed based on two alternatives**
  - safe equity as basis (Swiss model)
  - whole equity as basis (Classical model)

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B. Notional interest (5)

Computation

Notional interest computation

Assets	CHF	Equity basis %	Equity basis CHF	
Cash	25 000 000	0%	0	
Receivables	1 500 000	15%	225 000	
Other receivables	100 000	15%	15 000	
Listed shares	1 200 000	100%	1 200 000	
Participations	60 000 000	100%	60 000 000	
Loans to group companies	120 000 000	15%	18 000 000	
Equipment, premises	800 000	50%	400 000	
Starting costs	100 000	100%	100 000	
Intangibles	100 000	30%	30 000	
Total	**208 800 000**		**79 970 000**	*A*
Equity			**100 000 000**	*B*
Regular equity (Swiss rules)			**79 970 000**	*A*
Safe equity			**20 030 000**	*C= B-A*
Rate for notional interest deduction			**3%**	*D*
Deduction of notional interest based on classical model			**3 000 000**	*E=D*B*
Deduction of notional interest based on the Swiss model			**600 900**	*F=D*C*

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B. Notional interest (6)
Computation

- **Swiss solution not really advantageous**

Result: Deduction based on whole equity: CHF 3’000’000

Deduction based on safe equity: CHF 600’900

- **Proposal from business circles to apply a higher rate if evidenced by a transfer pricing study.**

Applicable to cantonal and federal income tax!

C. Reduction of cantonal profit tax

- Competence of the canton!
- Equalization of tax within Switzerland
- Confederation may help cantons to reduce their tax rate

D. Other Measures

1. **Abolition of issuance stamp duty**
2. **Improvement of participation reduction**
   - Amortisation
   - Losses

→participation exemption

→no threshold in terms of stake

→no statute of limitations for losses

→treatment at the parent level of losses incurred by subsidiaries

Measure not welcome by the business circles

3. **Withholding tax**
   - Paying agent instead of debtor
4. **Equity annual tax**
   - Abolition
   - Reduction if in relation with certain assets (investments, intragroug financing, intangibles)
     Not welcome by the cantons
5. **Tax based on tonnage for shipping activities or related activities (does not apply to companies purchasing/selling commodities)**
6. **Change in the way foreign taxes are credited to Swiss related income (imputation forfaitaire)**

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IV. The Long Way Forward (1)

Steps ahead

1. New consultation of the cantons until March 2014
2. Preliminary draft bill submitted to the Federal Council before Summer 2014
3. New Consultation with various cantons and business / scientific circles in Summer 2014
4. Draft bill submitted to the Swiss Parliament (votation)
5. Referendum possibilities
6. Entry into force of the ***new law*** (transitory provisions likely to be issued) if no referendum or referendum not successful

IV. The Long Way Forward (2)

Due to the complexity of the Swiss legislative process, the proposed changes contained in the Final Report, if implemented, will most likely be effective only in 2018-2021. Transitory rules should be carefully monitored for existing business.

- Cantonal profit tax rates

  The sensitive issue is whether important cantons close to Geneva and Zurich airports will be in a position to reduce significantly their profit tax rates. This should be closely monitored by companies which do not own IP, in particular most of US Principal companies or trading companies.

- Principal status – Finance branch

  As the principal status is granted based on a guideline of the federal administration, the practice may change quite quickly… without going through a legislative process. This does also apply to the finance branch (or company) status.

Questions and…..

Thank you very much for your attention !