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Third series of corporate tax reforms

Questions and answers

1. Tax policy aspects

a. *What is the thrust of the third series of corporate tax reforms in terms of tax policy?*

The reform remains based on the elements:

- Abolition of existing arrangements for mobile revenue and introduction of new ones that are in line with the current international standards;
- Lowering of cantonal profit tax rates;
- Other measures to improve the system of corporate tax legislation.

b. *What tax policy measures will be pursued?*

- Abolition of cantonal tax status; modification or elimination of administrative practices concerning principal companies and Swiss finance branches;
- Introduction of a patent box in the Tax Harmonisation Act based on the current international standard (in particular, the modified nexus approach);
- Introduction of the authorisation for cantons to provide for tax deductions for research and development;
- Introduction of adjustments for cantonal taxes on capital;
- Introduction of a system for the disclosure of hidden reserves at federal and cantonal level;
- Abolition of the issue tax on equity capital;
- Introduction of harmonised relief in the partial taxation procedure in the amount of 30% on qualifying holdings (at least 10%) at federal and cantonal level;

- Increase of the cantons' share of direct federal tax to 20.5% to ensure a balanced distribution of the financial burden of the CTR III;
- Weighting of the profits of legal entities with respect to resource potential in line with the relative fiscal capacity utilization;
- Provision of a short-term supplementary contribution to prevent cases of hardship in the financially weakest cantons.

c. *How heavy is the CTR III burden for the Confederation's finances?*

Estimates for the tax policy measures suggest a static decline of CHF 0.1 billion in the Confederation's receipts. Furthermore, there will be additional expenditure of CHF 1 billion for vertical equalization measures and the supplementary contribution of CHF 180 million for the financially weakest cantons. The total burden will thus be some CHF 1.3 billion.

Receipts-side measures	CHF bn
- Disclosure of hidden reserves	0.0
- Abolition of issue tax on equity capital	-0.2
- Adjustment of partial taxation of stakes of at least 10% of capital	0.1
Expenditure-side measures	
- Vertical equalization measures	-1.0
- Supplementary contribution	-0.2
Total reform	-1.3

d. *How heavy is the CTR III burden for the finances of the cantons and communes?*

From a static perspective, the following financial implications will result at cantonal and communal level: to the extent that revenue from companies previously taxed at a preferential rate will be taxed within the scope of the patent box, the reform will have a somewhat neutral impact on revenue at cantonal and communal level. However, receipts will fall as a result of the patent box if revenue previously taxed at a normal rate ends up in the patent box system. The capital tax adjustments and the disclosure of hidden reserves in the case of status loss will also have a more or less neutral impact on revenue overall. This last measure has a limited timeframe, however. The higher tax deductions for research and development will also result in lower receipts. As this is a voluntary measure, the extent of the decline in receipts depends on which cantons use the measure and to what extent. In contrast, additional receipts can be expected from the adjustment of the partial taxation procedure (0.1 billion).

e. *What dynamic financial implications are to be expected?*

To counteract the threatened exodus of mobile companies or the mobile tax base to other jurisdictions, a need may arise in the cantons to lower profit taxes as a result of abolishing cantonal tax statuses. Such profit tax reductions will also relieve the burden for companies previously taxed at a normal rate. Companies will adapt to the new national and international environment. Depending on the strategy chosen by the cantons and foreign countries in their tax policy, this may lead to either an influx or outflow of tax bases overall. In principle, Switzerland is likely to be well positioned for this: the reform will ensure that it continues to offer internationally competitive tax location parameters in the future with low tax burdens for financing activities (interest-adjusted profit tax, abolition of issue tax) and research-intensive activities (patent box, higher tax deductions for research and development) as well as a lower profit tax rate overall than at present.

f. Are patent boxes a good solution?

Patent boxes are a reality today in a number of competing locations and are therefore an effective tool for implementing a country's strategy in this area. Existing boxes are being scrutinised more closely by the OECD and the EU with regard to their compatibility with international standards. The outcomes of these investigations are now known to a large extent. The consultation resulted in broad approval for this measure. It should be limited to the cantonal tax level.

g. What considerations are behind the modified nexus approach?

With the modified nexus approach, only income that is based on domestic research and development expenditure qualifies for preferential taxation. In keeping with the model developed by the OECD, however, additional relief is also possible to a limited degree (uplift). Implementation of the modified nexus approach requires greater administrative resources than the model proposed in the consultation because expenses are now included in the calculation. The range of qualifying intellectual property rights should be limited to patents and similar rights, as established in the consultation draft.

h. What effects will the proposed patent box have for the individual cantons and for companies?

Patent boxes can be used by all companies that generate specific revenue from intangible assets. The effects at cantonal level will depend greatly on a canton's economic structure.

i. Why has the tonnage tax not been included in the dispatch?

It became apparent that the introduction of a tonnage tax could not be reconciled with the constitutional requirements.

j. Why was the interest-adjusted profit on above-average levels of equity capital abandoned?

The Federal Council is taking account of the results of the consultation procedure. Specifically, most of the cantons opposed the measure.

k. What are the capital tax adjustments like?

The cantons can introduce targeted reductions for patents and similar rights, as well as for shareholdings.

l. What is the idea behind increased deductions for research and development expenditure?

The cantons will have the option of making provision for increased tax deductions for domestic research and development in their cantonal law. The optional nature of this arrangement ensures that the cantons have the leeway to lower their profit tax rates if they believe this to be necessary to preserve their international competitiveness.

m. What do the cantons think about the abolition of the cantonal tax status?

The need for this measure was acknowledged by the vast majority of the consultation participants.

n. Why was the modification of the offsetting of losses and the participation deduction dropped?

The outcome of the consultation showed that a clear majority were not in favour of including this issue in the CTR III. This was also the case for the participation deduction.

o. How is the partial taxation procedure to be structured?

In order to avoid disincentives and lower receipts (including repercussions for AHV), the Federal Council is insisting on correcting the existing arrangement. This consists in harmonising the relief amount and the technical structure. The extent of taxation should be harmonised at 70% for the Confederation and the cantons. Most of the cantons were in favour of these two elements in the consultation procedure. However, privileged taxation should continue to apply only for participation rights of at least 10%.

2. International aspects

p. What is the connection between the third series of corporate tax reforms, the OECD's BEPS project, and the business taxation dialogue with the EU?

In order to maintain Switzerland's competitiveness as a business location, internationally acceptable concepts are required also in the area of corporate taxation. On the one hand, this means making certain adjustments to existing Swiss regulations which the EU believes distort competition and which are being reviewed by the OECD. On the other, the third series of corporate tax reforms will involve the introduction of new regulations that preserve the competitiveness of Switzerland as a business location.

The question of international acceptance therefore arises not just in respect of the EU, but also with regard to the OECD, whose BEPS (Base Erosion and Profit Shifting) project is likely to lead to an adjustment to international tax regulations.

q. Why is Switzerland not adopting the EU's Code of Conduct?

This is an internal code of conduct which applies only to EU member states. However, Switzerland is prepared to discuss individual business taxation aspects with the EU.

r. What has Switzerland achieved in the business taxation dialogue with the EU?

Switzerland's objective was to reach a balanced understanding with the EU which also encompasses the countermeasures taken on the EU side. Specifically, if Switzerland adjusts its corporate taxation to international standards and abolishes the controversial regimes, the countermeasures taken in the EU should likewise no longer apply. The EU's negotiation delegation has also been persuaded that there can be no question of Switzerland adopting the EU's Code of Conduct. The mutual understanding with the EU signed on 14 October 2014 takes account of these points.

Moreover, the understanding with the EU gives companies in Switzerland a certain degree of legal and planning certainty. An issue that has caused friction between the two sides for many years could finally be resolved. An understanding with the EU also has a positive impact on discussions in the OECD.

s. What developments are you expecting in the OECD over the next few months that could have repercussions for corporate taxation in Switzerland?

One aim of the BEPS project is to conclude a review of the tax regimes in OECD member states. Given that it was not possible to conclude this review last year as planned, the work will continue. The new aim is to conclude the review of all tax regimes by autumn 2015. Swiss tax regimes have also been under review since November 2012. Consequently, it is all the more important to press ahead with the reform.

t. *How is Switzerland positioning itself on the issue of corporate taxation in the OECD discussion and at the meetings of G20 finance ministers?*

Switzerland supports fair tax competition between countries, and welcomes initiatives that shape this principle fairly. Switzerland is therefore actively contributing to the work of the relevant working groups of the OECD's BEPS project. Two aspects are important to Switzerland:

- Fair competition between business locations must continue to be possible, including in relation to tax.
- International standards must apply universally, and in particular also to all financial centres and competing locations in Switzerland (level playing field).

u. *What type of patent box do you think is "BEPS compatible"?*

On 6 February 2015, the OECD announced an agreement on the parameters of the future standard for patent boxes. This is based on the so-called modified nexus approach. The FDF took full account of this important development in its preparation of the dispatch on the CTR III.

v. *Does the ongoing work on the BEPS project also concern other CTR III elements?*

The BEPS project will produce various other rules, best practice recommendations and standards. The outcomes are due in autumn 2015. Insofar as is necessary, the FDF will consider the implementation of the as yet pending outcomes of the BEPS project in a separate draft and submit corresponding proposals to the Federal Council in due course.

In September 2014, the OECD also published principles for the exchange of information on tax rulings. On 18 March 2015, the European Commission published a bill for the exchange of this type of information. The exchange of information on tax rulings will have to be considered for the measures introduced as part of the CTR III.

w. *Does the CTR III anticipate international developments in corporate taxation?*

No, measures that are in line with the currently applicable international standards will be introduced under the CTR III. Any possible leeway is fully exploited. Because the OECD standards and recommendations in particular are being developed further and precisely formulated under the BEPS project, future modifications of the Swiss measures can be expected.

x. *Why can trademark rights and innovation not qualify for the patent box system?*

One of the aims of the CTR III is to consolidate international acceptance of Swiss corporate taxation. The OECD standard for patent boxes allows tax privileges for income from patents and functionally similar intangible assets. Trademarks, however, do not qualify for a patent box.

3. Fiscal policy aspects

y. *How high are the federal and cantonal receipts generated from companies that have special tax status?*

Viewed as an average between 2009 and 2011 (most recent figures available), the corresponding profit tax receipts of the cantons and their communes, including the cantons' share, amounted to CHF 2.1 billion (21% of all profit tax receipts). Over the same period, the corresponding receipts of the Confederation amounted to around CHF 3.2 billion (49% of all profit tax receipts).

z. How significant are the individual statuses in question?

Measured in terms of profit tax receipts, so-called mixed companies are the most significant group, followed by domiciliary and holding companies. On a direct basis (i.e. in the form of a tax levy on the mobile profit tax bases themselves), the Confederation benefits significantly more from receiving the mobile tax bases, as it will continue to apply direct federal tax at a statutory rate of 8.5% to these. On an indirect basis, the cantons benefit more: on the one hand, they benefit from the income of employees of companies with mobile profit tax bases, and on the other, from the profits of companies that depend on the companies currently taxed at a preferential rate (and currently taxed normally) in value-added chains, and from the income of their employees as well as of downstream companies.

aa. How much is the corporate tax reform costing the Confederation and how is it being financed?

From a static approach, the proposed tax measures give rise to a net decline in receipts of CHF 0.1 billion. In addition, there are costs totalling CHF 1.2 billion for equalization measures and a temporary supplementary contribution for the cantons. The total cost will be financed through additional receipts (increased number of tax inspectors, 0.3 bn) and expenditure-side measures (total of around 1.0 bn). The most important element here is the cautious development of expenditure prior to the reform, which allows the cost of the reform to be absorbed without any additional expenditure-side measures. The measures decided by the Federal Council to adjust the budget will ensure that the remaining burden can be absorbed without short-term expenditure cuts, despite the weaker fiscal policy outlook. The CTR III will be factored into financial planning for the first time with the 2017-2019 legislature financial plan.

bb. How does the extent of the vertical equalization measures come about?

The total volume of the vertical *equalization measures* is derived essentially from the financial impact of the cantonal profit tax reductions. This is dependent on the *difference between the receipt losses of the cantons and the Confederation* that result from the reform. The vertical equalization amounts to *half of this difference*. Consequently, the burden resulting from the cantonal profit tax reductions *will be split equally between the cantons and the Confederation*. The calculations were done using a model (based on plausible assumptions) of the manner in which the average profit tax burden of companies in Switzerland changes. The cantons are more affected by these changes, hence the Confederation's participation.

cc. What instruments are to be used to implement the vertical equalization?

The tax competition between the cantons should be distorted as little as possible. Given this premise, the equalization should take the form of an increase in the cantons' share of direct federal tax.

dd. Does a canton automatically benefit more from the Confederation's vertical equalization measures if it cuts its profit tax rate to a greater degree?

The vertical equalization measures are designed in such a way that they cannot be directly influenced by cantonal tax policy. They are designed to increase cantonal freedom of manoeuvre in the area of fiscal policy generally and in the long term, and cannot be influenced by the specific tax policy of a canton.

ee. Won't cantons be put under pressure (e.g. to cut profit tax) if the Confederation sets out the vertical equalization on an ex ante basis?

Despite the tax policy measures, profit tax cuts may prove to be unavoidable, depending on the specific situation of a canton. The equalization measures are to be stipulated in advance in order to give the cantons planning certainty. It is not yet clear whether (and to what extent) the cantons will reduce profit taxes, and how companies will respond to this

development. As a result of these uncertainties, the vertical equalization measures will have to be laid down on the basis of assumptions. In the wake of implementation of the reform, the degree to which the vertical equalization measures achieve their objective will be reviewed, and if necessary an application will be made to Parliament for their adjustment.

ff. Why is an adjustment to the fiscal equalization system necessary?

With an abolition of cantonal tax statuses, domestic and foreign revenue would be factored into the calculation of resource potential with a full weighting (due to the discontinuation of beta factors). Without adjustment measures, this would result in massive dislocations (in particular a much higher resource potential for any canton with many status companies), without anything changing fundamentally in terms of the economic power of the cantons.

gg. Which cantons will be the winners and which will be the losers as a result of the resource equalization adjustment?

It is too early to make a firm statement in this respect. The resource equalization adjustment will occur with a time delay of four years, i.e. probably not until 2023. Simulations have shown that there is a great deal of uncertainty regarding the effects of this adjustment.

hh. Why is Switzerland now taking a smaller share of company profits in tax?

The combination of the new special regulations and cuts to cantonal profit tax rates will have two effects. On the one hand, companies currently taxed in the ordinary way would benefit from a generally lower tax rate if cantons cut their profit tax rate. On the other, a number of mobile companies could move elsewhere, as the introduction of a standard rate would not allow for competitive taxation. Both of these developments would lead to lower capacity utilization.

ii. Is there any incentive for cantons to maintain mobile corporate tax bases now if this entails a significant increase in their resource potential?

The reduced weighting of corporate profits in resource potential will improve the incentive to take measures to preserve the corresponding tax base.

jj. Aggregated tax base (ATB): Why is the tax rate levied on company profits lower than that for personal income?

Corporate profits have a greater degree of mobility, which means this segment of the tax base cannot be exploited to the same extent. This is also corroborated by data: by comparison, the fiscal capacity utilization of legal entities' profits is lower than that of personal income.

kk. Why are the beta factors not simply continued for the new boxes?

The discontinuation of tax statuses also means that beta factors can no longer be included in calculations. They will be replaced by factors known as zeta factors, which are based on relative capacity utilization.