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Switzerland Referendum Approves Tax Reform

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Key Findings

- On May 19, after more than four years since the first effort to reform the Swiss tax system, voters accepted proposed changes to their tax system. The reform is expected to be in effect by 2020.
- Swiss cantons will no longer be able to lower multinationals' corporate tax rates; instead, all companies will be subject to the same tax rate.
- Patent boxes at the cantonal level will allow for preferential tax treatment of profits derived from patents, and cantons will be able to allow for R&D deductions.
- Taxes on dividends will be increased and cantons will receive a higher share of federal tax collections.
- Estimates show that the reform will lead to an annual decline in corporate tax revenue of CHF 2.2 billion (USD $2.2 billion) in the short term.
- Tax reform was initially motivated by the agreement made between the Swiss government and the European Union (EU) to conform the Swiss tax system to standards suggested by the Organisation for Economic Co-operation and Development (OECD).
- With the reform, there is an ongoing concern that the tax increase will lead to corporations looking to relocate to jurisdictions with more favorable tax conditions.
- The main objectives of the reform are to keep Switzerland an attractive business location, to gain international acceptance, to avoid sanctions from the EU, and to improve the effective use of tax revenues at all governmental levels.

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Introduction

On May 19, Swiss voters approved a tax reform package in a referendum. The reform will bring the tax system closer to EU and OECD standards on taxation of multinational businesses. This reform will also allow Switzerland to avoid being placed on the OECD or the EU blacklist, a consequence that would harm the business environment for multinationals domiciled in Switzerland. The ongoing Swiss tax reform debate is connected to the impact the reforms can have on a high number of multinational companies in the country (about 24,000)[1] and the ongoing concern on what would happen if those companies were to leave the country. In Switzerland, multinational companies generate about a quarter of employment and one-third of the gross domestic product.[2]

The tax reform eliminates some of the characteristic features of the Swiss system, with the most relevant being the preferential tax regimes at the canton level. (Cantons are the equivalent to a state in Switzerland.) Prior to the reform, Swiss cantons were responsible for establishing tax rates and multinational companies could negotiate with cantonal governments on preferences like lower rates or tax holidays, depending on different conditions. Following the reform, this preferential treatment will no longer be allowed. The federal government will increase the share of federal tax to cantons to compensate them for the revenue shortfall.

In addition to removing opportunities for preferences at the cantonal level, the Swiss tax reform added a patent box regime in line with OECD recommendations, an additional research and development (R&D) deduction, and other reforms.

The corporate income tax in Switzerland accounted for 11.5 percent of revenue in 2017.[3]

Background

Switzerland has a unique corporate tax system among European countries. In the last several years the European Union (EU) and the Organization for Economic Co-operation and Development (OECD) have focused on the Swiss system, and both organizations have been consistently trying to push the country to eliminate the privileges granted to multinational companies. From the EU and OECD point of view, the special privileges afforded by the Swiss system to multinational companies are unfair tax competition policy.

Switzerland is in the middle of Europe and is one of the European countries that decided not to be part of the EU nor of the European Economic Area (EEA). The country has developed a strong tax treaty network of over 80 treaties[4] in force, with more than 30 of them based on the OECD model treaty. This has attracted many multinational companies from different European countries to domicile in Swiss territory.

1 Michael Shields, "Swiss voters approve tax and pension overhaul," Reuters, May 19, 2019, https://www.reuters.com/article/us-swiss-tax/swiss-voters-approve-tax-and-pension-overhaul-tv-idUSKCN1SP0AO.

2 PwC, "Swiss Tax Reform: Referendum successfully called, public vote on 19 May 2019," Jan. 17, 2019, https://www.pwc.ch/en/publications/2019/Swiss-Tax-Reform-EN-web.pdf.

3 Elke Asen and Daniel Bunn, "Sources of Government Revenue in the OECD, 2019," Tax Foundation, April 23, 2019, https://taxfoundation.org/sources-government-revenue-oecd-2019/.

4 European Union, "Treaties office database: List of treaties signed by Switzerland," http://ec.europa.eu/world/agreements/searchByCountryAndContinent.do?countryId=3820&countryName=Switzerland&countryFlag=treaties.

The Swiss system is characterized by its preferential regime for multinationals, and the country has not adopted most of the OECD, EU, or EEA regulations (nor has it been required to). In 1972, the country managed to sign a free-trade agreement with the European Economic Community,[5] facilitating better relations for Swiss multinationals with other European countries. The country also negotiated access to parts of the EU single market, another attractive element for Swiss companies.

Other relevant agreements signed by the country include agreements for the free movement of people, agriculture, technical trade barriers, science, and the Schengen membership. The combined result is that Swiss companies are able to trade under similar conditions to companies located in other EEA or EU member countries, but without facing the same regulatory or tax rules established in other European countries.

In recent years there has been pressure from the EU and OECD and other individual countries to have Switzerland placed on a blacklist unless it adopted a tax reform to conform its tax system to international norms. When a country is placed on a blacklist for tax purposes, companies within that country can face higher tax rates on their income when doing business in other countries. This created pressure for the Swiss government to pursue tax reform.

Not only is the Swiss tax system different from many other countries, the Swiss legislative system is also different from other systems. Switzerland is a direct democracy, which means that often, Swiss citizens can participate directly in decision-making through referenda. From the legal perspective,[6] the system allows citizens to decide the approval of federal proposals and cantonal reform proposals by voting on a referendum.

In 2015 the country started a legislative initiative to enact a tax reform to conform with European standards to keep the country attractive to investors and avoid being blacklisted. After a series of efforts (including a previous failed referendum in 2017), the referendum on the Federal Act on Tax Reform and AHV Financing (TRAF) was approved with more than 60 percent of the votes on May 19, 2019.

The Swiss Finance Ministry estimates that the reform will decrease tax revenue by about CHF 2.2 billion (USD $2.18 billion) annually.[7] The estimates show that tax collections from corporations currently structured as cantonal holding companies (cantonal status companies) will increase by CHF 2.3 billion, while revenue from companies without preferential tax treatment will decrease by CHF 4.5 billion.[8]

5 The Treaty of Lisbon merged the three pillars (European Communities, Common Foreign and Security Policy, and Cooperation in Justice and Home Affairs) and abolished the European Community, with the European Union becoming its legal successor.

6 *The Local*, "How Switzerland's direct democracy system works," May 23, 2018, https://www.thelocal.ch/20180523/how-switzerlands-direct-democracy-system-works.

7 The exchange rate is 1 CHF = 0.99 USD.

8 Swiss Confederation Federal Tax Administration, "Dynamische Schätzung der Einnahmeeffekte der Steuervorlage 17," March 19, 2018, https://www.estv.admin.ch/dam/estv/de/dokumente/allgemein/Dokumentation/Zahlen_fakten/botschaften/steuervorlage17/Studie-Dynamische-Effekte-SV17.pdf.download.pdf/Studie-Dynamische-Effekte-SV17_d-f.pdf.

The following table summarizes the main points of the Swiss tax reform.

TABLE 1.

Application of the Swiss tax reform

Taxes	Cantonal	Federal
Patent box	Mandatory	No
Corporate income tax reduction	Optional	No
Research and Development (R&D) deduction	Optional	No
Two-rate system	Mandatory	No
Immigration step-up in basis	Mandatory	Yes
Capital gains relief	Optional	No
Notional interest deduction	Optional	No

Source: Swiss Finance Ministry / Reuters

A brief explanation of some of the features of the reform, including changes to the federal tax regime and to the cantonal tax regime, follows.

Abolishment of preferential tax regimes

One of the main complaints of the international community about the Swiss tax system was the existence of preferential tax regimes for cantonal holding companies (cantonal status companies). Currently, the corporate income tax rates multinational companies pay are generally not disclosed and can be negotiated with the Swiss canton on an individual basis. TRAF repeals those benefits.

TRAF includes transitional measures and a five-year window to facilitate privileged companies transitioning to an ordinary taxation system at the cantonal level. At the federal level those companies will continue to pay the full corporate income tax.

According to estimates of the Swiss Finance Ministry,[9] the effective corporate income tax rates before and after the reform will be the following:

TABLE 2.

Effective corporate income tax rates before and after the reform by type of business

	Before the reform	After the reform	Percentage-point difference
Businesses currently not benefiting from preferential tax treatment	19.52%	14.33%	-5.19
Businesses currently benefiting from preferential tax treatment	8.82%	11.33%	+2.51
All businesses	14.14%	12.82%	-1.32

Source: Swiss Finance Ministry

9 Id.

Businesses currently not benefiting from preferential tax treatment will face a lower effective rate after the reform, and companies that have had a preferred status will face a higher rate. However, due to further changes in the tax code (see below), their effective tax rates will still differ after the reform. Overall, the effective tax rate will decrease.

Estimates from the Swiss Finance Ministry show that eliminating the preferential tax regimes will affect the three levels of government—federal, cantons, and municipalities—in different ways. While the federal government will see a slight increase in tax revenue, cantons and municipalities will face a sharp decrease.

TABLE 3.

Estimated change in tax revenue by government level and type of business in 2020

(in millions of Swiss francs)

Federal Government	
Businesses currently not benefiting from preferential tax treatment	+379
Businesses currently benefiting from preferential tax treatment	-81
Net change	+298
Cantons and Municipalities	
Businesses currently not benefiting from preferential tax treatment	-4,864
Businesses currently benefiting from preferential tax treatment	+2,368
Net change	-2,496
Total change	**-2,199**

Source: Swiss Finance Ministry

Cantons and municipalities will receive about CHF 4.9 billion less in taxes from businesses currently not benefiting from preferential tax treatment. However, tax revenue from businesses that currently have a special tax status are estimated to pay an additional CHF 2.4 billion to cantons and municipalities.

To cover the resulting revenue shortfall of around CHF 2.5 billion, the federal government will increase the share of federal tax that cantons receive.[10]

Estimates also show that taxes on profits will decline by CHF 1.9 billion and taxes on capital by CHF 0.3 billion due to the elimination of the preferential tax regimes, adding up to the total of CHF 2.2 billion.

10 Michael Shields, "Swiss voters approve tax and pension overhaul."

Disclosure of hidden reserves

Companies relocating to Switzerland will benefit from the so-called step-up system (the tax basis will be readjusted, and the appreciated value is used for depreciation purposes). Hidden reserves, including self-created goodwill, can be disclosed tax-free and benefit from additional depreciation in the first years.

Currently, the cantons have two models: a five-year special rate taxation on realization (the so-called two-rate system) or a tax-free revaluation of these hidden reserves in the tax balance sheet with corresponding tax effective depreciation (the so-called step-up model).

Companies that are currently subject to a special tax regime will be able to review whether their tax status will be waived before 2020 when tax reform comes into force and can determine whether they will be able to benefit from the step-up in basis.

Patent box regime adjusted to the OECD standard

A patent box regime gives a favorable treatment for patents and similar rights to be taxed at a lower level to incentivize research and development.

The TRAF limits the use of benefits for patent boxes only to income linked to an intellectual property right registered in a public register. Copyright-protected software (not patented) is excluded from the patent box. The new standard is applied only at cantonal discretion and has been adjusted to follow the OECD recommended standard. Taxpayers can only benefit from a special IP regime what they have incurred in R&D that is related to the IP income (the modified nexus approach under BEPS Action 5). The existence of substantial activities when specific benefits for IP take place is a requirement under the new approach.

With the new standard, net profits from domestic and foreign patents and similar rights are to be taxed separately, with a maximum tax base reduction of 90 percent on such income. In other words, cantons must tax at least 10 percent of profits derived from patents.

Research and development additional deduction

TRAF includes an additional deduction for research and development (R&D) expenses as optional and applicable at each canton's discretion to a maximum of 50 percent of costs. The basis for the additional deduction is limited to research personnel expenses plus 35 percent (for other R&D costs) or 80 percent of R&D expenses incurred and invoiced by third parties or group companies in Switzerland.[11]

11 Id.

Notional Interest Deduction (NID)

TRAF includes an optional measure at the cantonal level that provides for a deduction of a notional interest on surplus equity (or excess capital). As designed, the deduction is exclusively applicable for cantons in which businesses pay effective corporate tax rates of at least 18.03 percent (federal, cantonal, and local combined). The only canton that probably would be entitled to introduce this measure is Zurich.[12]

Overall tax relief limited to 70%

TRAF has mandated a minimum level of taxable profit at the cantonal level. The measure limits the tax relief from patent boxes, the special deduction for R&D, and the notional interest deduction to 70 percent of profits. A minimum taxable profit of 30 percent should be maintained by the cantons.[13]

Adjustments in taxation of dividend income from qualifying participations

Before TRAF, dividend income from qualifying participations that were held as business assets was partially exempt to mitigate double taxation at the shareholder level. The federal tax rate was 50 percent on business investments and 60 percent on private investments. The standard federal rate after the reform is 70 percent.

Qualifying participations have their origin in the participation exemption regime where dividends and capital gains are not taxed under certain conditions, or when a tax applicable for relief from taxation is provided in specific cases. Under Swiss tax law a participation is considered qualifying if the recipient company owns at least 10 percent of the payer company or the value of the participation is at least one million Swiss francs.

At the cantonal level each canton had a different level of taxation, ranging from 30 to 70 percent. Harmonization of the relief method (irrecoverable foreign taxes on investment income can be credited under certain conditions) and a minimum rate of 50 percent are part of the reform.

Capital tax relief

Another feature of the privileged regime was that companies benefited from a low tax rate on capital gains. As part of the elimination of privileged regimes, the new law allows cantons to choose if they provide a capital tax relief on equity capital attributable to patents and related rights, qualifying participations, and intra-group loans to compensate for the elimination of the privileged regimes.[14]

12 Catherine Bosley, "What the Swiss Vote on Taxes Means for Multinationals," Bloomberg, May 15, 2019, https://www.bloomberg.com/news/articles/2019-05-15/what-swiss-vote-on-taxes-means-for-multinationals-quicktake-q-a.

13 Jean-Blaise Eckert and Frédéric Neukomm, "Switzerland's 2019 push for corporate tax reform," *International Tax Review*, March 13, 2019, https://www.internationaltaxreview.com/Article/3863947/Switzerlands-2019-push-for-corporate-tax-reform.html?ArticleId=3863947.

14 EY, "Swiss Parliament approves tax reform package," *Global Tax Alert*, Sept. 28, 2018, https://www.ey.com/Publication/vwLUAssets/Swiss_Parliament_approves_tax_reform_package/$FILE/2018G_011235-18Gbl_Swiss%20Parliament%20approves%20tax%20reform%20package.pdf.

Capital contribution principle restrictions

Swiss companies listed on Swiss stock exchanges may only pay tax-free capital contribution reserves if they pay taxable dividends in the same amount.

This does not affect intra-group dividends and capital contribution reserves from assets transferred to Switzerland after February 24, 2008 (and in the case of a liquidation). The rules also apply to the issue of bonus shares and nominal value increases from capital contribution reserves.[15]

Extension of the flat-rate tax credits on foreign companies' permanent establishments

Swiss permanent establishments of foreign companies can continue to claim withholding taxes on income from third countries with a flat-rate tax credit. This was created for the purpose of eliminating double taxation.

Social compensation via the AHV (Old-Age and Survivors Insurance)

The AHV is the state-run insurance in Switzerland. It is designed to provide retirement pensions and other allowances. As mentioned, as a consequence of tax reform there is a projected short-term revenue reduction of 2.2 billion Swiss francs. This revenue shortfall is planned to be compensated with an increase on the annual contributions to the pension system on the following terms:

There will be a 0.3 percent increase in payroll taxes, with half the legal incidence on employers and half on employees. The shortfall also will be compensated with the allocation of part of the federal share on value-added tax (VAT) to cover the AHV (the amount assigned to each canton will be determined according to their share of the total population). Finally, there will be an increase in the federal contribution to the AHV to 20.2 percent.

Cantonal profit tax rates

There will be a reduction of the profit tax rates of each Canton, that is not directly related to the reform that was approved. Cantons will receive a higher share of the federal direct tax, something that will allow them to reduce their tax rates to keep them attractive as investment destinations.

Conclusion

Even if it is expected that the reform in the short term in Switzerland will drop corporate income tax collection by about 2.2 million francs, the reform is necessary to keep the country competitive with other low-tax countries and conform to international rules. While going forward cantons cannot negotiate preferential tax rates, they can now provide their businesses with other benefits, including R&D tax breaks and notional interest deductions (NID). The reform represents a necessary modification to the tax system to avoid having the country put on the EU blacklist, which would have harmed the business environment for multinationals.

15 Id.