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Switzerland: Significant changes in the tax landscape expected for international business operations

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This article is addressed to tax directors of international groups with operations in Switzerland.

Many Swiss operations of international groups benefit from special tax regimes. Switzerland will introduce significant changes to these special tax regimes in order to be compliant with international standards and to maintain its attractiveness as a location for international business.

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I. Introduction: Switzerland attracts many international businesses and inbound investments for various reasons, including prudent government spending, an agreement on free personal movement with the European Union (EU) and a stable political and legal system. As is widely known, Switzerland also offers a reasonably low tax rate. In particular, enterprises doing business internationally may benefit from special tax regimes.
For example, profits from trading activities or royalty and financing income may be taxed according to the *mixed company status* or specific rules applicable to *finance branches*. Also, Switzerland has a broad double tax treaty network, does not have any controlled foreign company (CFC) or subject to tax rules and hence is very attractive as an international *holding location*. Also, the excellent accessibility to a highly qualified work force and the outstanding quality of life make Switzerland attractive as a location to centralize senior management and important group functions. Such operations may benefit from the special Swiss *principal status*.

II. The Past: Switzerland is one of the world's most attractive locations to do international business and is therefore home to thousands of international enterprises. As a result, Switzerland is the benchmark and is in the spotlight of its competitors.
In 2007, the EU expressed its opinion that certain Swiss cantonal tax regimes would constitute illegitimate state aid. The EU in particular challenged the mixed and holding company regimes. In 2008, Switzerland announced a corporate tax reform (**corporate tax reform III**) in order to address these concerns. In the meantime, a steering committee was appointed to develop new solutions that would be acceptable to the EU and would maintain and improve Switzerland's attractiveness, especially for mobile operations. In May 2013, the steering committee published its first interim report. On December 19, 2013, an additional report to the attention of the Swiss finance ministry (the "**report**") was published. The report states that Switzerland is willing to replace the following five tax regimes: (1) mixed company, (2) domiciliary company, (3) holding company, (4) principal company and (5) finance branch. The report explicitly mentions that Switzerland wants to remain very attractive, especially for holding, headquarters, IP (intellectual property) and trading related activities. In this respect, the report lists the international tax rate benchmark: group internal dividend distributions 0%, group internal interest income 2-3%, royalty income 5-8% and international trading profit 10-12%.

III. The Future (expected changes): Switzerland, as a member state of the Organization for the Economic Co-ordination and Development (OECD), must obey the organization's recommendations. Any new solutions introduced by the corporate tax reform III must be compliant with the work of the OECD's forum against harmful tax practices. Also to be considered is the action plan "BEPS" (base erosion and profit shifting) which aims to (1) secure taxation of profits at the place of the effective commercial activity, (2) avoid aggressive tax planning and (3) eliminate international double non-taxation.

The report sets out the following solutions which are specifically designed to replace the existing Cantonal tax regimes:

- Introduction of an IP/Innovation box: by virtue of an IP/Innovation box, royalty income is being taxed separately from other income. Some EU member states offer IP boxes and hence, they are widely accepted. The Swiss IP box will significantly reduce the ordinary cantonal/communal income tax rate (reduction in the range of 80%) while the Federal effective tax rate remains at 7.83%. The specific details of the Swiss IP box is subject to further discussions. In view of the international tax developments, the main discussion topics are: (1) the nature of qualifying IP, (2) the level of local substance and activity required (entry test) and (3) the method to determine the qualifying IP profit (bottom up/net license approach vs. top down/residual profit approach). It is also worth mentioning that not only the beneficial treatment of the output-side (royalty income) is analyzed, but also further evaluations are undertaken with respect to tax incentives for R&D expenses (input-side).
- Notional interest deduction on part of the equity (allowance for corporate equity, "ACE"): In Switzerland, interest expense on loan payables is tax deductible. The report proposes to introduce a notional interest deduction on equity whereby the deduction would be granted on the portion of the equity that exceeds the core capital (deduction on "higher-than-average" equity). Also here, the financial impact and the calculation method are subject to further analysis.
- General reduction of the cantonal income tax rate: Depending on the specific design of the IP box (narrow vs. broad design), the Cantons might reduce their ordinary income tax rate for all companies. How and to which extent the Federation may cross finance such tax rate reductions will be further analyzed.

In addition, the report discusses various other amendments to the current Swiss tax law in order to further improve Switzerland's attractiveness and competitiveness:

- Introduction of a tonnage tax system for shipping companies.
- Introduction of a paying agent system for withholding tax purposes in order to make Switzerland more attractive as location to issue public debt.
- Abolishment of the issuance stamp tax.
- Possibility of a step up in basis to allow companies moving their legal seat from abroad to Switzerland to amortize their stepped up assets tax effectively for many years.
- Other (tax technical) changes in connection with the participation relief, the annual capital tax and the tax credit system.

VI. Conclusion and timeline: There are many details of the corporate tax reform III still to be further analyzed and defined. In any case, taking into account the report's clear commitment to an attractive and competitive tax environment, the corporate tax reform III will ensure that Switzerland can continue its success story in the future.

Based on what we know today, the following can be concluded:

- The currently granted privileged tax regimes still are valid and still can be applied also for new businesses.
- The report clearly states that companies transitioning from a privileged status to an ordinarily taxed status can step up (revalue) their assets to fair market value. The stepped up values can be amortized tax effectively. This ensures enough planning time even after the enactment of the corporate tax reform.
- A 5-7 year timeline is expected until the corporate tax reform III will be effective. Hence, there is no need for companies to make any immediate (hasty) decisions.
- Nevertheless, many Swiss based operations of international corporations benefit from one of the above mentioned special tax regimes. Therefore, tax directors of such groups should closely monitor the Swiss corporate tax reform III.

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MME Partners advises national and international corporations and groups in the areas of relocation, business reorganizations, M&A transactions, financing structures, intellectual property structures, and international double taxation issues. Furthermore, MME Partners represents clients in complex negotiations with cantonal and federal tax authorities, as well as in appeal procedures.

Due to his previous work as leader of the Swiss tax desk of PwC in New York City, Dr. Samuel Bussmann has vast experience rendering cross-border advice to U.S. multinational enterprises with both U.S. and international tax questions.

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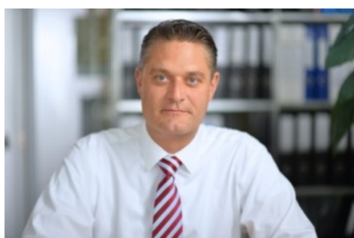

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