Switzerland – On its way in a changing international tax environment

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Switzerland has a long standing reputation for its favourable and competitive tax environment for corporate entities as well as individuals. However, recent developments in the international tax environment have set Switzerland under pressure to amend the Swiss tax regime to comply with the international criticism, on the one hand, and to reinforce its international tax competitiveness, on the other. In the focus of the criticism mainly from the European Community but also from the OECD are the present tax regimes for the Swiss holding company as well as the regimes for domiciliary and mixed companies. Furthermore, some of the international tax allocations schemes for corporate entities such as the principal structure face more and more international pressure. Switzerland has also changed its strategy as a financial centre. The Swiss Bankers Association's strategy is now focused on two main objectives: legal certainty and growth, and the banks are committed to comply with international tax compliance standards even if this means the implementation of an international automatic exchange of information.

Summary of recent developments in Swiss tax law

In the last few years Switzerland implemented several measures to strengthen its attractiveness. In 2011 Switzerland implemented the capital contribution principle which allows the repayment of contributed equity to the shareholders including a most favourable retroactivity for equity contributions in previous years.

In 2013 the Federal Act on the Taxation of Employee Participations was introduced to grant legal certainty for participation schemes. Furthermore the Swiss withholding tax on intra group financing interest payments was abolished.

Also in 2013 the new Swiss law on the international assistance in tax matters came into force which now allows "group requests" for tax information and pushed the amendment of a most significant part of the international tax treaties to grant exchange of information between Switzerland and its treaty partners.

Switzerland also concluded a model 2 agreement with the US to comply with the FATCA regulations. Still on its way is the so-called "corporate tax reform III" which will be crucial for the international tax position of Switzerland.

Swiss Corporate Tax Reform III (CTR III) on its way

Introduction

Switzerland's privileged taxation system for holdings, mixed and domiciliary companies is under increasing international pressure, in particular from the European Union (EU) and the Organisation for Economic Cooperation and Development (OECD).

Several changes in the Swiss tax legislation are currently being prepared and discussed by the federal and the cantonal governments. On December 19, 2013, the Swiss Federal Council issued a final report on "measurements to strengthen competitiveness of the Swiss tax system".

In the final report, the Swiss Government confirms the commitment to strengthen the competitiveness of Switzerland as a leading global business location and foster its fiscal attractiveness. For the time being, the Swiss Government states that the internationally competitive tax burden is currently 0% for intra-group dividends, 2%-3% for intra-group interest income, 5%-8% for royalties and 10%-12% for international wholesale trading income.

The main propositions outlined in the final report can be summarised as follows:

- introduction of new regulations for mobile earnings (i.e. licence box and notional interest deduction);
- lowering of cantonal tax rates;
- abolishment of certain tax burdens to enhance the general business location attractiveness.

The main tools in detail

Licence box. The report postulates the introduction of a nationwide licence box system in order to support the use of intellectual property. The new Swiss licence box model shall offer the same or similar benefits as granted today by licence/IP box regimes in place within other EU countries.

The new Swiss licence box regime shall be applicable for the cantonal/communal taxes and therefore be integrated in the Swiss tax harmonisation act as well. The extent of such privileged taxation (reduced IP tax rates or reduction of qualifying IP income/tax base) shall be subject to the individual decision of each canton.

The definition of the qualifying IP income has to be worked out in detail. However, currently it is not scheduled to implement an extremely broad definition of IP. In some cantons, constructs similar to licences boxes are discussed (e.g. innovation boxes in the canton of Basel City).

It is likely that some of the cantons should have the ability to significantly reduce the applicable tax burden for qualifying IP income and compensate the loss of attractiveness caused by an abolition of the tax privileges currently still in force.

Notional interest deduction on equity. A notional interest deduction on equity (NID) ensures the equal tax treatment of equity and debt. Since fiscal considerations shall not have an impact on financing decisions, NID regimes are internationally accepted.

The report qualifies the introduction of an NID regime as a potential alternative for the Swiss tax system on the cantonal and the federal tax level.

The report, however, states that additional clarifications are needed. Furthermore, the report indicates that a Swiss NID regime system might be limited to a so-called "Surplus-Equity" as the basis for the NID calculation. Surplus-Equity shall be defined as the part of equity which exceeds the average, sound equity financing of a company (depending on the activities of the company). The details of such an NID regime (e.g. applicable interest rate, calculation of surplus equity) still need to be determined. Although NID regimes are in place in certain countries, Switzerland would be the first country with a Surplus-Equity approach.

The NID regime as currently suggested would be an effective way to reduce a holding company's or mixed company's taxable income in case of a strong equity basis.

Reduction of cantonal corporate income tax rates. As a general compensation measure, the cantonal and communal income tax rates could be reduced. Each canton needs to evaluate and decide on the extent of such tax rate decrease. In the end, the average statutory cantonal tax rates of some 18% could be reduced to an average of some 14% (rates calculated on profit after tax).

Such tax rate reductions may lead to effective tax rates in Switzerland (including the direct federal tax) amounting to some 12%-14% (rates calculated on profit before tax). Finally, it has to be stated that already several cantons offer effective statutory tax rates (including the direct federal tax) in the range of 12%-15%.

Other tools of CTR III. Further measures discussed and to be implemented by CTR III are the abolition of the issuance stamp tax, changes to the participation exemption, the option to waive the annual capital tax and changes to the Swiss withholding tax regime (implementation of a paying agent system for interest payments).

Besides the measures as specified above, the report states that the abolishment of the privileged cantonal taxation regimes should allow for a tax-free step-up of the built-in gains that were created during the privileged taxation period. In its decision dated March 13, 2012, the Swiss Supreme Court came to the same conclusion. However, the details of such step-up and the potential subsequent amortisation of the higher tax bases still need to be defined.

Next steps

A draft law, to be prepared by the Federal Council, will be announced for spring 2014. The official consultation of the draft law is scheduled for summer 2014. The law-making process in Switzerland, including a potential public referendum, may take several years. Therefore, it is currently expected that the Corporate Tax Reform III will come into force not earlier than 2018.

Even though the current rules will stay applicable in the meantime, it is important for companies to evaluate the impact and the opportunities of the upcoming changes at the appropriate time.

FATCA – investment companies

In 2009 Switzerland and the US signed a protocol to include a provision for the exchange of information for tax purposes based on group requests in the double tax treaty. In 2013 Switzerland and the US entered into an agreement for the implementation of FATCA for Swiss resident financial institutions.

The agreement follows the Model II approach and provides an exchange of information based on a respective group request under the amended double tax treaty by the US. Swiss financial institutions have to register for FATCA purposes until April 25, 2014. The agreement and the respective Swiss legislation will be set in force by July 1, 2014.

As Switzerland offers an attractive tax and legal environment it hosts a significant number of private equity investment companies for participation in start-up, life science and other operative non-financial institutions which are regularly held by Swiss and foreign resident investors.

It was and still is, therefore, a challenge in our daily practice to qualify such vehicles under FATCA. A significant number of such entities are not regulated under the Swiss money laundering act and are not under the supervision of the Swiss Financial Market Supervision Authority FINMA. The crucial part of the

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qualification work therefore is to define if such investment companies are managed by professional service providers and therefore qualify as financial institutions under FATCA or if those entities have to be qualified as non-financial foreign institutions.

Amendment of double taxation agreement network

In order to comply with the international information exchange requirements, Switzerland does great effort in the amendment of its extensive network of double taxation agreements (DTA) and entering into new DTA and tax information exchange agreements (TIEA).

For the time being, the Swiss DTA and TIEA network comprises 114 agreements, whereof already 42 DTA (36 already in force) comply with the OECD standard.

Conclusions

Despite the reputation as a stable tax location, Switzerland is on its way to bring its tax regimes in line with international standards on fair tax competition.

In order to achieve sustainable and long-lasting solutions to keep its reputation as a reliable tax location, careful research and consideration are required. Although Switzerland is not fully compliant with all present international demands, the presentation of well-adjusted proactive solutions, which fit into our present tax system, will bring Switzerland forward into a future as a prime tax location.

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