Tax Alert

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Swiss Tax Law Changes: Federal Act on Tax Reform and AHV Financing (TRAF)

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Key points

- Switzerland's privileged taxation of companies is no longer in line with international standards.
- In 2017, the first attempt to abolish the internationally criticized regime was clearly rejected by Swiss voters.
- On 28 September 2018, the new legislative proposal, TRAF, was accepted by the Swiss Parliament.
- The act, subject to an optional referendum, could enter into force on 1 January 2020.
- Corporate groups with a Swiss presence should consider the potential impact of those proposed tax measures.

Introduction

Under Swiss law, companies are subject to federal income taxes on their worldwide net income. Switzerland operates tax at two levels: the federal level and the cantonal level. The overall rate varies depending on the canton in question. The approximate range for the effective combined corporate income tax is typically between around 12 percent and 25 percent depending on the location of the corporation. Currently, the actual corporate income tax in the Canton of Luzern is approximately 12.3 percent and 14.6 percent in the Canton of Zug.

There are tax privileges on the cantonal status companies:

- **Holding companies** tax regime is granted to companies whose primary purpose is the holding of shares and that have no active trade or business in Switzerland. Such companies are exempt from cantonal and communal income taxes. At the federal level, a relief for dividends and capital gain is granted. The federal income tax on other income (e.g., interest, royalties) amounts to 7.8 percent.

- **Mixed companies** tax regime is granted to companies with limited commercial activities in Switzerland. In principle, this means at least 80 percent of the income is derived from foreign sources, and at least 80 percent of the costs are incurred abroad. Foreign-sourced income is typically subject to a combined effective rate between 9 percent and 11 percent. Income derived from Switzerland is taxed at ordinary rates.
- **Domicile companies** tax regime is available for companies that carry out only administrative functions in Switzerland, without any commercial activities. A domicile company is in principle subject to an effective tax rate of 8 percent to 11 percent on its foreign-source Swiss-sourced income is subject to ordinary tax rates.
- **Finance branches** tax regime may be applicable in a case in which a legal entity provides financing functions (at least 75 percent) mainly for related companies (total assets of at least CHF 100 million). The effective income tax rate amounts to 1 percent to 2 percent.
- **Principal companies** tax regime applies to entities that centralize the functions and risks within the group and perform business through contract manufacturing and limited risk distributors ("LRDs") and commissionaires. LRDs and commissionaires must perform limited-risk distribution exclusively (i.e., at least 90 percent of the net profit of the distribution company is derived from LRD). The gross margin of the LRDs or commissionaires cannot exceed 3 percent. Furthermore, principal companies must prove sufficient substance in Switzerland. The overall effective income tax rate for the principal headquarters varies between 5 percent and 8 percent.

The background to Swiss tax reform

The current Swiss tax system and the above mentioned tax privileges are no longer in line with international standards. In order to avoid being put on a blacklist of tax havens, Switzerland undertook to abolish the tax privileges.

On 12 February 2017, Swiss voters rejected the third series of corporate tax reforms (CTR III) abolishing the internationally criticized regimes.

In order for Switzerland to remain an attractive business location, the Swiss Federal Council launched Tax proposal 17 (TP17), a new reform in collaboration with representatives of the confederation, the cantons, the cities, political parties, and business and employer associations.

The objectives were the following:

- boosting appeal as a business location
- international acceptance
- productivity of tax revenue

The recommendations were adopted on 1 June 2017 by the steering body.

On 9 June 2017, the Federal Council discussed the tax policy reform and adopted the parameters for TP17 in the process. It largely took on board the recommendations of the steering body.

The Federal Council adopted the dispatch on 21 March 2018.

On 7 June 2018, the legislative proposal was in the Council of States (first chamber of the Swiss parliament). As a result of the tax reform, tax losses of CHF 2 billion per year. The Council of States compensated this shortfall through the Old-Age and Survivor's Insurance (AHV). Consequently, the project was called the Federal Act on Tax Reform and AHV Financing (TRAF).

On 28 September 2018, TRAF was accepted by the Swiss Parliament. A potential referendum on TRAF is planned to be held on 19 May 2019. If the new act is not subject to an optional referendum or if TRAF is accepted by the public vote, the act should enter into force on 1 January 2020.

The cantons should be motivated to lower their tax rate in the framework of TP17. However, the reductions of tax rates are decided autonomously by the cantons and independently from the corporate tax reform under way at the federal level. For example, legislative plans for the canton of Vaud include a reduced corporate tax rate of 13.79 percent (from 20.95 percent) to be effective 1 January 2019.

Key points of TRAF

The main measure of TRAF is the abolition of the above mentioned tax privileges. However, in order for Switzerland to remain an attractive business location, new tax special arrangements will be introduced:

- **Patent box:** Under TRAF, an OECD compliant patent box will be introduced at the cantonal level. Patent boxes will allow a portion of the profits from inventions to be taxed at a reduced tax rate in the cantons in the future.
- **R&D expenditures:** In addition, the cantons will have the possibility to institute an additional deduction of R&D costs up to a maximum of 50 percent above the effectively incurred costs of companies.
- **Notional interest deduction (NID):** High-tax cantons (e.g., Zurich) will have the possibility to introduce a notional interest deduction.
- **Tax relief limitation:** The patent box, the R&D expenditures and the NID are accompanied by an overall tax relief restriction; the total tax burden may only be reduced by a maximum of 70 percent.
- **Increase of partial taxation of dividends:** Currently, dividend income from qualifying participations (i.e., at least 10 percent of the nominal capital in a corporate entity) is partially exempt from taxation in order to mitigate double taxation. Today, at the federal level, only 60 percent of the private investments and 50 percent of the business investments are taxable. At the cantonal level, the thresholds vary between 35 percent and 70 percent. Under TRAF, a standard rate of 70 percent will be applicable at the federal level. At the cantonal level, there will be a minimum taxation rate of 50 percent.
- **Additional AHV financing:** It is anticipated that TRAF will lead to tax losses of CHF 2 billion per year. Approximately half of the funds will be financed by an increase of 0.3 percent in salary contributions, to be borne half by the employers and half by the employees. The remainder will be financed by existing VAT and an increase in federal contribution to the AHV.

- **Optional capital tax relief:** The cantons will have the possibility to reduce the taxable capital on patents (and similar rights) and on intra-group loans.
- **Step-up relocation:** Foreign companies relocating to Switzerland will be entitled to disclose hidden reserves and benefit from depreciation in the first years (the step-up relocation).
- **Increase of the canton's share of federal tax revenue:** Currently The canton's share of the federal direct tax will be increased from 17 percent to 21.2 percent. This should enable the cantons to reduce their tax rates.
- **Transposition:** Currently, private individuals can in principle sell less than 5 percent of the capital in a Swiss company to a company in which they own more than 50 percent tax free. This 5 percent quota will be eliminated.
- **Capital contribution:** Swiss publicly listed companies will no longer be entitled to repay first, tax free, capital contribution reserves in case of retained earnings; they will need to pay an equal amount of dividends subject to withholding tax. This repayment rule will not apply to intra-group dividends and capital contribution reserves created after 24 February 2008 or in the case of a liquidation.