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Newsletter

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TAX

Adoption of the Federal Act on Tax Reform and AHV Financing: Roadmap of the Changes

On 19 May 2019, the Swiss public voted for the adoption of the Federal Act on Tax Reform and Financing of the AHV ("**TRAF**"). The key elements of the TRAF will likely enter into force on 1 January 2020. There is no transitional period for the cantons, thus they also have to adapt their cantonal legislation by this date. Most cantons have already taken steps in this direction.

1 BACKGROUND

The course for a Swiss tax reform was set in 2013 due to the demands of the European Union ("**EU**") and the action plan of the OECD and the G20 on Base Erosion and Profit Shifting ("**BEPS**"). Switzerland communicated its willingness to the EU (in accordance with the Memorandum of Understanding dated 14 October 2014) and to the OECD to abolish the tax privileges that were considered harmful. These tax privileges apply to holding companies, domicile and mixed companies on the cantonal level, and to principal companies and "Swiss Finance Branch"-structures on the federal level (collectively referred to as "**tax regimes**").

Originally it was planned to abolish the cantonal tax regimes as part of the Corporate Tax Reform III ("**CTR III**") as of 1 January 2019. However, a referendum was held and the Swiss voters rejected CTR III on 12 February 2017.

As a consequence, the Federal Council revised the bill. On 28 September 2018, the Parliament adopted the revised Federal Act on Tax Reform and Financing of Social Insurance ("**AHV**"), in short "**TRAF**". As a major innovation, the tax proposal was linked to AHV financing. The TRAF measures were discussed in our newsletter of October 2018. On 17 January 2019, the Young SVP, the Young FDP and the Left-Green Alliance, again, initiated a referendum against TRAF.

On 19 May 2019, Switzerland voted on the tax reform for the second time, and this time, the bill was accepted with 66.4% supporting votes.

2 CURRENT STATUS

As Switzerland is under strong international pressure to abolish the tax regimes, the country has made concessions to that effect.

Since 5 December 2017, **Switzerland has been on the EU grey list**. Countries on the EU's grey list have assured the EU that they would amend the tax practices which are considered to be harmful. The EU set a deadline for Switzerland until the end of 2019 to abolish its tax regimes.

The Federal Tax Administration ("**FTA**") had already announced in November 2018 that, as of 1 January 2019, no more tax regimes would be granted on a federal level for new companies (i.e. principal companies and taxation as Swiss Finance Branches). According to the dispatch of the Federal Council, with the entry into force of TRAF it is also intended to abolish the existing tax regimes at federal level. Contrary to the regulations of the cantonal tax regimes, the abolition of the federal practices does not require any adjustment of the law.

"The key elements of the TRAF will enter into force on 1 January 2020, with no transition periods for the cantons."

3 IMPLEMENTATION OF TRAF

3.1 IMPLEMENTATION SCHEDULE AND STEP-UP

The majority of the TRAF measures will likely **enter into force on 1 January 2020**. This concerns in particular the abolition of the legal provisions on cantonal tax regimes. As an exception, the provision on the special rate solution enters into force immediately, i.e. on 20 May 2019 (nArt. 78g of the Cantonal and Communal Income Tax Harmonization Act ("**CCITHA**")).

In accordance with the provision on the special rate solution, hidden reserves, including the created added value ("**goodwill**"), can be taxed separately on the transfer of a cantonal tax regime to ordinary taxation ("**change of status**") in the event of realization within the next five years and to the extent that these were not taxable ("**new-law step-up**" or "**special rate solution**"). The cantons are free to determine the form of the special rate; accordingly, the cantonal implementation plans vary (published special rates vary between 0.5% and 4%; flat-rate or progressive structure).

Some cantons already provide for the option of disclosing hidden reserves in the event of a change of status ("**current-law step-up**" or "**disclosure solution**"). With the current-law step-up, hidden reserves (including goodwill) can be capitalized in the tax balance sheet and then amortized for tax purposes in accordance with the depreciation tables.

The earlier introduction of the special rate solution is designed to enable companies to abolish their tax regime before the end of 2019. If a current-law step-up is also possible, there should be a choice between a current-law and a new-law step-up in the event of a change of status. However, whether such a right to choose is granted lies solely at the cantons' discretion. Companies affected by a change of status must consider which method is more suitable for them.

3.2 IMPLEMENTATION ON FEDERAL LEVEL

The following tax measures are planned at federal level:

> Increase in partial taxation of dividends from qualifying holdings (minimum 10% of share capital) of individuals held as private or business assets to 70%;

> Extension of the transposition rule (removal of the exception for participations below 5%);

> Disclosure of hidden reserves as of the beginning of a tax liability in Switzerland and taxation of hidden reserves upon migration from Switzerland (exit taxation);

> Introduction of a repayment and partial liquidation rule under the capital contribution principle ("**CCP**");

> Extension of the tax credit of foreign withholding taxes to Swiss permanent establishments of foreign companies.

In particular, these measures require amendments to the corresponding articles of the Federal Income Tax Act ("**FITA**") and the Withholding Tax Act ("**WHTA**"). At federal level, no profit tax reduction is planned; the profit tax rate remains at 8.5% respectively 7.83% for corporations and cooperatives. On 10 April 2019, the Federal Council also sent the following TRAF ordinances to consultation, which will last until 17 July 2019:

> Ordinance on tax deduction on self-financing of legal entities;

> Ordinance on the tax credit related to foreign taxes levied at source (formerly known as ordinance on flat-rate tax crediting); and

> Ordinance 1 of the Federal Department of Finance ("**FDF**") on the tax credit related to foreign taxes levied at source.

The ordinances are expected to come into force with the TRAF on 1 January 2020.

"The Federal Council has already started consultations on the TRAF ordinances."

The ordinance on tax deduction on self-financing of legal entities is based on nArt. 25a^{bis} para. 6 CCITHA. According to this provision, the cantons may grant a notional interest deduction on equity exceeding the minimum required equity ("**core equity**") subject to compliance with the requirements of Art. 25a^{bis} para. 1 CCITHA. The exceeding equity is referred to as surplus equity. In particular, the ordinance stipulates how this surplus equity is to be calculated (definition of minimum equity ratios) and defines the level of the notional interest rate to be applied. The FTA will publish the notional interest rate annually. Currently, only the Canton of Zurich can introduce this measure.

Pursuant to the double taxation treaties concluded by Switzerland, foreign withholding taxes on interest, dividends and licenses (partly also on pensions or service income) can be credited against taxes owed in Switzerland. According to the credit method, the aforementioned income is not exempt from taxation in Switzerland, but the taxes paid in the other state can be credited to the Swiss taxes (maximum amount). Until now, only individuals, legal persons or partnerships domiciled in Switzerland were entitled to a flat-rate tax credit. In future, permanent establishments in Switzerland of foreign companies will be newly eligible to this as well.

The existing ordinances will be amended accordingly. Additional changes are planned, such as the abolition of the reduction of the tax credit amount in the case of partial taxation in Switzerland (i.e. through the partial taxation of dividend income).

It is expected that further ordinances and/or circular letters related to the implementation of the TRAF will be issued in the course of 2019.

3.3 IMPLEMENTATION ON CANTONAL LEVEL

The cantons will have to adapt their legislation by 1 January 2020 (no transitional period). In case of non-adaption the TRAF provisions set forth in the CCITHA are directly applicable as of 1 January 2020.

In addition to the TRAF measures, most cantons intend to take further complementary measures. These are in particular reductions in profit tax rates. Significant profit tax reductions are planned in the cantons GE, JU, FR and VS (VD has already adopted a reduced tax rate), but also in BS, BL, SO and TI. Most cantons have already opened corresponding consultations on the amendment of cantonal tax laws so that the amendments can enter into force with the TRAF on 1 January 2020.

In addition to the measures that are mandatory on the cantonal level under the TRAF (i.e. the abolition of cantonal tax regimes, the restriction of the CCP), there are also measures in the full discretion of the cantons.

> "Most cantons also provide for additional complementary measures (reductions of profit and capital tax rates)."

PATENT BOX

The implementation of the patent box is mandatory at cantonal level. The patent box allows for qualifying net profits from patents and comparable rights ("**patent box profit**") to be included in the assessment basis to a reduced extent. The cantons are free to determine the level of taxation of the patent box profit (but at least 10%, i.e. a maximum exemption of 90%, is possible). A reduction of the exemption for patent box profits may reduce its attractiveness. Half of the cantons provide for a maximum exemption of 90%. In seven cantons, however, the exemption of patent box profits will be less than 50% (AI, GE, GL, LU, NE, TG, and UR).

Pursuant to nArt. 24b para. 4 CCITHA, the Federal Council is to issue further provisions on the calculation of patent box profits, documentation obligations, etc. A corresponding draft regulation was sent to consultation already in 2017.

ADDITIONAL DEDUCTION FOR EXPENDITURE ON RESEARCH AND DEVELOPMENT ("R&D")

In connection with the patent box, the cantons can give higher weight to R&D expenditure (max. 50% increase). Two thirds of the cantons grant a super deduction of up to 50%. Nine cantons have announced that they will not grant a R&D super deduction (AI, BS, GL, GR, LU, NW, SH, TG and UR).

LEVEL OF RELIEF LIMITATION

The TRAF stipulates that the entire tax relief granted in accordance with nArt. 24b para. 1 and 2 (patent box), nArt. 25a (R&D super deduction), Art. 25abis (deduction on self-financing) and nArt. 78g para. 3 (depreciation due to current-law step-up) CCITHA and thus may not be higher than 70% of the taxable profit before loss offsetting. The cantons may also provide for smaller reductions. Any difference in the maximum relief limit would be added back to the taxable profit. More than half of the cantons plan a lower relief limit (approx. 40% to 50%). The lowest limits are planned in GE (9%), GL (10%), LU (20%) and FR (20%).

REDUCTION OF CAPITAL TAX

The cantons may provide that the equity attributable to participations, patents and similar rights as well as intra-group loans is included in the calculation of the capital tax at a reduced rate. Practically all cantons provide for a reduction in capital tax. This is based not only on the option introduced by the TRAF of taking qualified equity into account on a reduced amount, but also on general capital tax reductions.

INCREASE IN PARTIAL TAXATION OF DIVIDENDS

According to TRAF, income from qualifying participations, i.e. dividends, profit shares, liquidation surpluses and non-cash benefits of individuals, is taxable at a rate of at least 50%. Qualifying participations are participation rights of at least 10% in a corporation or cooperative. Cantons may provide for higher taxation. According to cantonal regulations, only AI, AG, GL and UR would have to increase in partial taxation. However, more than half of the other cantons foresee an increase in partial taxation to approx. 60% to 80% (AR, BL, BS, FR, GE, GR, JU, LU, NE, SG, SH, SO and TG).

4 CONCLUSION AND OUTLOOK

With the adoption of the TRAF, Switzerland will likely be removed from the grey list of the EU. As a result, Switzerland will no longer be under international scrutiny.

> "The adoption of the TRAF not only ensures Switzerland's removal from the grey list but also secures its international competitiveness."

The implementation of the TRAF – combined with other planned measures at cantonal level (as a rule, reductions in the rate of income tax) – will change the tax landscape in Switzerland. The financial impact of the TRAF is difficult to assess and will only become apparent in the future. However, the TRAF ensures that Switzerland can secure its international competitiveness and restore legal certainty, which is important for Switzerland as a tax location.

Companies are advised to carefully analyze the effects of the TRAF. In particular, companies will have to identify by which measures they are affected and from which measures they can benefit. In particular, companies that are taxed under a tax regime must determine when to switch to ordinary taxation.

The decision on the TRAF has little influence on the scheduled AHV revision ("**AHV 21**"), as the resulting financing of approximately CHF 2 billion merely covers a part of the AHV's financial requirements. AHV 21 will be adjusted accordingly following the adoption of the TRAF. The Federal Council plans to submit AHV 21 to Parliament before the end of 2019.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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