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TAX

Third Reform of Corporate Taxation: Selected Topics

Due to pressure by the European Union and the OECD, Switzerland just agreed to abolish the Swiss special tax regimes for holding, mixed, domiciliary and principal companies as well as the Swiss Finance Branch regime at the earliest by 2018. This newsletter focuses on two issues linked with the related legislative proposal of the third corporate taxation reform (RIE III). The newsletter first describes the step-up and deprecation of hidden reserves resulting from a change from the privileged tax regime to the ordinary tax regime (*the step-up*). Secondly, it examines the notional interest deduction proposal (*"NID"*, also called the interest adjusted corporate income tax).

1 THIRD REFORM OF CORPORATE TAXATION (RIE III)

1.1 INTERNATIONAL CONTEXT AND OBJECTIVES PURSUED

In the context of **international tax harmonisation**, the European Union ("**EU**") expects Switzerland to adapt its tax laws to EU standards, following the principle that the special **tax regimes** currently in force in Switzerland are a form of **detrimental tax competition**. In particular, the EU considers that the tax regimes granted to certain companies (holding companies, mixed companies, domiciliary companies, principal companies and Swiss finance branches) represent prohibited state support within the meaning of Switzerland's free trade agreement of 1972, therefore creating a distortion of competition within the EU common market.

Believing that the elimination of the special tax regimes will harm Switzerland's competiveness in the tax field, the Federal Department of Finance ("**FDF**") has, on behalf of the Federal Council, created a commission to develop proposals to compensate for the elimination of the special tax regimes, while being compatible with current international tax standards.

Following the commission's first preliminary report published in May 2013 and consultations with the Swiss cantons and business associations, the commission continued its work, leading to a second report that was published by the FDF in December 2013.

1.2 POLITICAL AND FISCAL MEASURES

Among the measures to bolster Swiss competitiveness following elimination of special tax regimes, the first, named RIE III, introduces **privileged taxation of licence income** ("***licence box***"). Under this measure, the return on a company's intangible property is separated from its other revenues and benefits from more favourable taxation than ordinary income.

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The second measure proposed is the implementation, at a federal and cantonal level, of the adjustment of corporate taxable corporate income by a **deduction of notional interest on equity capital**.

Finally, a third measure would reduce **cantonal tax rates on corporate income, would eliminate stamp duty on the issuance** of equity capital, the **tonnage tax** and would provide other reductions of the cantonal tax on capital.

2 ELIMINATION OF SPECIAL TAX REGIMES: TAX-RELATED CONSEQUENCES UPON TRANSITION FROM A PRIVILEGED STATUS TO AN ORDINARY TAX REGIME (HIDDEN RESERVES)

2.1 SPECIAL CANTONAL TAX REGIMES

Swiss cantons currently apply a **special taxation system** for certain types of companies. Article 28 of the Swiss Federal Act on Harmonisation of Direct Cantonal and Municipal Taxes (**LHID**) permits cantonal and municipal income tax relief for holding, auxiliary or mixed companies as well as for companies qualified as domiciliary companies. Such tax relief does not, however, extend to Swiss federal taxation. Thus, **the companies that benefit from cantonal tax reductions are still subject to full federal income tax** on the same basis as ordinary corporations.

Under the third reform of corporate taxation, the elimination of special tax regimes will require a **transition from the special tax regime to an ordinary tax regime** for the companies concerned.

2.2 ACCOUNTING PRINCIPLES AND CORRECTIVE TAX RULES

Under the "**determinative**" **principle**, Swiss tax authorities determine a corporation's taxable income on the basis of its financial statements. However, although the tax law follows the rules of accounting law, the Swiss legislation provides that the "determinative" principle may be modified by certain exceptions. Thus, the tax authorities may amend certain results that follow from the strict application of accounting rules.

The two issues discussed below represent exceptions that are made to the determinative principle by the tax authorities.

2.3 IMPLEMENTATION OF *STEP-UP* IN THE CONTEXT OF THE REFORM

In addition to a change in the manner of taxing future profits, the change to an ordinary tax regime can result in other consequences for the companies involved, including the taxation of appreciation in the value of assets **that has not been booked**, sometimes called **hidden reserves**. Similarly, a change in the tax regime may raise the question as to the treatment of **losses** that were sustained under the old tax regime but that **may be carried forward for tax purposes**. In other words, it may be necessary to determine, on one hand, whether the "old" losses may be offset against future profits and also to determine how the hidden reserves of the companies changing tax regime should be treated. Those two related questions are discussed below as issues of ***step-up***.

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As in the case of the Federal Act on Federal Direct Tax (**LIFD**), the LHID does not currently contain any corrective tax rules allowing taxation upon the transition from a special taxation system to an ordinary one. **Until now, the cantons have been free** to implement their own practices, resulting in varying solutions.

For example, certain cantons authorise only a limited re-evaluation of hidden reserves during the tax period preceding the loss of a special status, but allow for losses to be carried forward. Other cantons, such as **the canton of Geneva**, allow a company to include in its tax-related balance sheet the hidden reserves accumulated during the tax-neutral holding regime during the tax period preceding the changeover to ordinary taxation system (*step-up*). However, the tax losses that can be carried forward disappear upon the change to an ordinary taxation system.

All of those practices have been deemed **permissible by the Federal Supreme Court**, leaving open the question as to which approach will be followed under the current third reform.

Although the commission's report is not explicit on this point, it seems likely that the **practice of the canton of Geneva** will be proposed, as the report states that "the law currently in force is already familiar with such cases of transition from a special taxation system to an ordinary taxation system", and it appears to be "justified to show, in the tax-relevant balance sheet the as hidden reserves that were created or generated while the company benefited from a special tax regime without those reserves having any tax-related impact." upon the change of regime. The report also notes that "the tax return must be filed during the last tax period for which the company benefits from a tax regime." It does not, however, give a clear indication of the fate of losses that are carried forward for tax purposes.

In any case, the Federal Supreme Court has approved the principles followed by Geneva, as they provide a symmetrical treatment by providing that potential losses that are carried forward shall not be taken into account. Thus, the only question that remains is how the LHID will be modified under the current reform, with a view to **harmonising the different cantonal practices**.

3 CORPORATE INCOME TAX ADJUSTED FOR NOTIONAL INTEREST

3.1 INTRODUCTION

Corporate income tax adjusted for notional interest is intended to eliminate **the existing discrimination between equity and debt financing**. Indeed, the classic corporate income tax rule, within certain limits, currently provides for the deduction of interest on debt from the taxable base as costs justified by commercial use (Art. 59 LIFD; Art. 25 LHID), whereas the deduction of amounts on equity capital (initial capital outlay and accumulated profits) is not permitted.

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3.2 MECHANISM

The global taxable capital of a company may be subdivided into **two categories**:

- **Base equity capital** ("**BEC**"), determined by the amount of capital that a company needs for its long-term commercial activity and therefore that represents equity financing that is considered reasonable; and
- **Surplus (or so-called security) equity capital**, being the difference between the total taxable capital and the base equity capital.

Only the notional interest related to surplus equity capital would be deductible. Whereas base equity capital can be distributed only based on the company's after tax profits via dividends, the surplus equity is beyond those limitations and is the voluntary part of the corporation's financing and corresponds to a "financial loan" and should therefore bear interest.

3.3 CALCULATION OF BASE AND SURPLUS EQUITY CAPITAL

Base equity capital is calculated according to the different types of the company's assets. First, each type of asset is assigned a base equity capital **ratio** determined on the basis of the risk linked to the asset in question.

For example, a company's participations in subsidiary companies or real estate would be fully covered by the base equity capital (a ratio of 100%), whereas the ratio for receivables would be only 15%. Liquid assets would not be covered (thus a ratio of 0%)

Those ratios would enable each company to determine the amount of its base equity capital, for example:

Type of asset	CHF	BEC Ratio %	BEC CHF
Liquid assets	2'000'000	0 %	0
Real estate	5'000'000	100 %	5'000'000
Participations	1'000'000	100 %	1'000'000
Receivables	1'000'000	15 %	150'000
TOTAL	**9'000'000**	**63.33 %**	**6'150'000**

Once the total base equity capital has been calculated, it is deducted from the total amount of the company's equity capital in order to determine the surplus equity capital.

3.4 NOTIONAL INTEREST DEDUCTION ("NID")

Second, the value of the **surplus equity capital** would be multiplied by the **rate used for the deduction of notional interest**, which would be set "with a goal of competitiveness of the economy." According to the model of the working group, the rate would be set at 3%:

Equity capital of the company	10'000'000
Base equity capital	6'150'000
Surplus equity capital	3'850'000
Rate for notional interest deduction	3%
Notional interest deductible from taxable corporate income	**115'500**

4 COMMENTS OF THE CANTONS AND NEXT STEPS

The report of the commission of the third reform of corporate taxation of 11 December 2013 was submitted to the cantons, to the Conference of the cantonal directors of finance (**CDF**), to the Conference of cantonal governments (**CdC**) as well as to four Swiss business associations. Although the strategic orientation of the reform has been **approved as a whole by the cantons**, the majority of cantons believed that the preferential taxation of license income should be examined in further detail. The introduction of corporate income tax adjusted for notional interest and other tax measures were not, however, deemed to be a priority by most cantons, essentially because of the uncertainty impact on their tax revenues. However, certain cantons and the business associations welcomed the proposals.

"The resulting legislation will enter into force in 2018 at the earliest, and will hopefully reflect a balance among recognition of international norms, tax competiveness and an assured provision of tax revenues."

The FDF must submit a **final report and propose legislation** to the Federal Council. Such submission may occur during the second half of 2014. Nevertheless, the resulting legislation will enter into force **in 2018 at the earliest**, and will hopefully reflect a balance among recognition of international norms, tax competiveness and an assured provision of tax revenues.

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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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