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Global Tax Alert

Switzerland to hold public referendum on Swiss tax and social security reform

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Executive summary

On 17 January 2019, the referendum period relating to the draft *Federal Act on Tax Reform and AHV (Old-Age and Survivors Insurance) Financing* (TRAF), formerly referred to as Tax Proposal 17, expired. The left-green committee against the TRAF – which mainly consists of the green party, smaller left-wing parties, unions and some non-governmental organizations (NGOs) – announced that it successfully collected the required 50,000 signatures to call for a public referendum against the tax and social security reform proposal. Even though the official confirmation of the referendum is still pending, the popular vote will likely take place on 19 May 2019. Accordingly, taxpayers will have legal certainty regarding the outcome of the referendum within a relatively short period of time.

Most major political parties support the reform proposal. In mid-December, it was still open whether or not the left-green committee against TRAF would successfully gather the necessary number of signatures. Compared to the previous referendum, the timely collection of the signatures was rather slow and required extra efforts by members of the referendum committee. Other opposing groups were only able to collect a few thousand signatures.

This Alert summarizes the key measures under the proposed tax reform. For further information please register for our Webcast on TRAF on 5 February 2019, 1:30 pm CEST.

Building a better working world

Detailed discussion

Background

The tax reform's objective is to maintain the long-term attractiveness of Switzerland as an international business location and to restore international acceptance of the Swiss tax system. At the same time, the tax framework is intended to secure an appropriate level of tax revenue. The tax reform foresees the replacement of certain preferential tax regimes with a new set of internationally accepted measures.

The legislative changes align with the intention of a broad reduction of the cantonal corporate tax rates. Important business locations in Switzerland target a combined federal and cantonal tax rate of approximately 12-14%.

The last proposed tax reform with the same goal – Corporate Tax Reform III – was rejected by the Swiss voters at the beginning of 2017. Since the need for tax reform was undisputed, the Federal Council immediately drew up a new proposal. Based on the experience of the rejection of the Corporate Tax Reform III, TRAF is more balanced and includes additional AHV financing measures as a form of socio-political compensation.

Core tax measures

Abolishment of existing tax regimes

At the cantonal level, tax privileges for holding companies, domicile companies and mixed companies are to be terminated. At the federal level, the profit allocation rules of principal companies and Swiss finance branches are to be repealed. The Swiss Federal Tax Administration confirmed in a letter dated 15 November 2018, that it will no longer apply the federal practices concerning principal companies and Swiss finance branches to new companies from 2019. With the entry into force of TRAF at the beginning of 2020, the federal practices for existing principal companies and Swiss finance branches will also be abolished.

Patent box with a maximum relief of 90%, mandatory at cantonal level

A core element is the introduction of a patent box regime in accordance with the Organisation for Economic Co-operation and Development standard. In the box, net profits from domestic and foreign patents and similar rights are to be taxed separately with a maximum reduction of 90%.

R&D super deduction of 50% maximum, optional at cantonal level

The introduction of this super deduction for domestic research and development (R&D) is Switzerland's commitment to be recognized as an attractive location for R&D. For administrative reasons, the maximum deduction of 50% is limited to personnel expenses for R&D plus a flat-rate surcharge of 35% for other costs and 80% of expenses for domestic R&D carried out by third parties or group companies.

Notional interest deduction, optional at cantonal level

High-tax cantons have the possibility of introducing a notional interest deduction on excess capital. According to the current intentions of the cantonal governments, only the canton of Zurich would meet the requirements.

Disclosure of hidden reserves

Hidden reserves including any self-created goodwill at the moment of the transition from privileged to ordinary taxation or migration to Switzerland are confirmed by the tax authorities.

In the case of a migration to Switzerland, the so called step-up system is applied. The tax-free disclosed hidden reserves are to be depreciated annually at the rate applied for tax purposes to the respective assets.

In the case of a transition, the so called two-rate system is applied. Profits relating to the realization of hidden reserves that were generated under a privileged tax regime are subject to a separate tax rate. The cantons are free to determine the amount of the special tax rate. The two-rate system ensures a competitive income tax burden during a five-year transition period.

Overall tax relief of 70%, mandatory at cantonal level

The patent box, R&D super deduction, notional interest deduction as well as possible depreciations from the early transition from privileged to ordinary taxation are subject to the overall tax relief of 70%.

Additional measures

Adjustments in taxation of dividend income from qualifying participations

Dividend income of individuals from qualifying participations is currently already partially exempt from taxation. At the federal level, the taxation rate increases from 50% (business investments) and 60% (private investments) respectively to a standard rate of 70%. At the cantonal level, there is a harmonization of the relief method and an introduction of a maximum relief of 50%.

Capital tax relief, optional at cantonal level

Privileged taxed companies usually profit from a low capital tax rate. In order to compensate for the loss of this tax advantage, the cantons are given the opportunity to reduce the capital tax rate on patents and similar rights, qualifying participations and intra-group loans.

Adjustments of the capital contribution principle

Companies listed on a Swiss stock exchange may only repay capital contribution reserves free of Swiss dividend withholding tax if they pay taxable dividends in the same amount (50/50 rule). Not affected by this scheme are in particular capital contribution reserves: (i) created in the context of a cross-border merger, restructuring or immigration after 24 February 2008; (ii) capital contribution reserves repaid to qualifying shareholders (at least 10% quota); and (iii) capital contribution reserves repaid as a result of a liquidation/transfer of domicile or PoEM (place of effective management) abroad. The 50/50 rule shall also apply to the issue of bonus shares and nominal value increases from capital contribution reserves.

Extension of the flat-rate tax credits on foreign companies' permanent establishments

Swiss permanent establishments of foreign companies should be able to claim withholding taxes on income from third countries with a flat-rate tax credit.

Social compensation via the AHV (old-age and survivors insurance – OASI)

It is assumed that the loss of tax receipts due to the tax reform will amount to CHF2b (in a static view). This shortfall will be compensated through the OASI contributions:

- 0.3% increase in salary contributions (employers and employees one half each)
- Allocation of the federal share of the demographic percentage of Value Added Tax to the OASI
- Increase in the federal contribution to the OASI from the current 19.55% to 20.2%

Reduction of cantonal income tax rates

The reduction of cantonal income tax rates is not directly covered by TRAF but is necessary to remain attractive from a tax perspective for former tax privileged companies. The increase of the canton's share of the federal direct tax from 17% to 21.2% enables the cantons to reduce their tax rates. Based on official announcements made by the cantonal governments, it is expected that the majority of the Swiss cantons will provide attractive tax rates on pre-tax income between 12% and 18% (including federal tax).

Outlook

As mentioned at the outset, the popular vote will take place on 19 May 2019. The entry into force of TRAF is still planned for 2020 even though this is an ambitious timeline for the cantons to implement the required cantonal reform packages. Therefore, some cantons, such as Vaud and Basel-Stadt, are implementing or have already implemented the revised cantonal tax laws in parallel with the federal reform. In other cantons, the governments released guidance on how they plan to amend the cantonal tax legislation to continue to provide for an attractive tax framework for international and domestic companies.

Regardless of the outcome of the popular vote, companies should anticipate the replacement of the preferential tax regimes starting 2020 and plan the transition into the new regulations. The tight time frame requires swift planning from taxpayers and companies should start preparing now for the upcoming legislative changes.

The European Union (EU) gave Switzerland until the end of 2018 to abolish the internationally no longer accepted tax privileges. The EU finance ministers will meet in March 2019 for a general update on the tax policy.

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