Corporate Tax Reform III: Facts & Figures

(translation from position paper by economiesuisse)

1. What is it about?

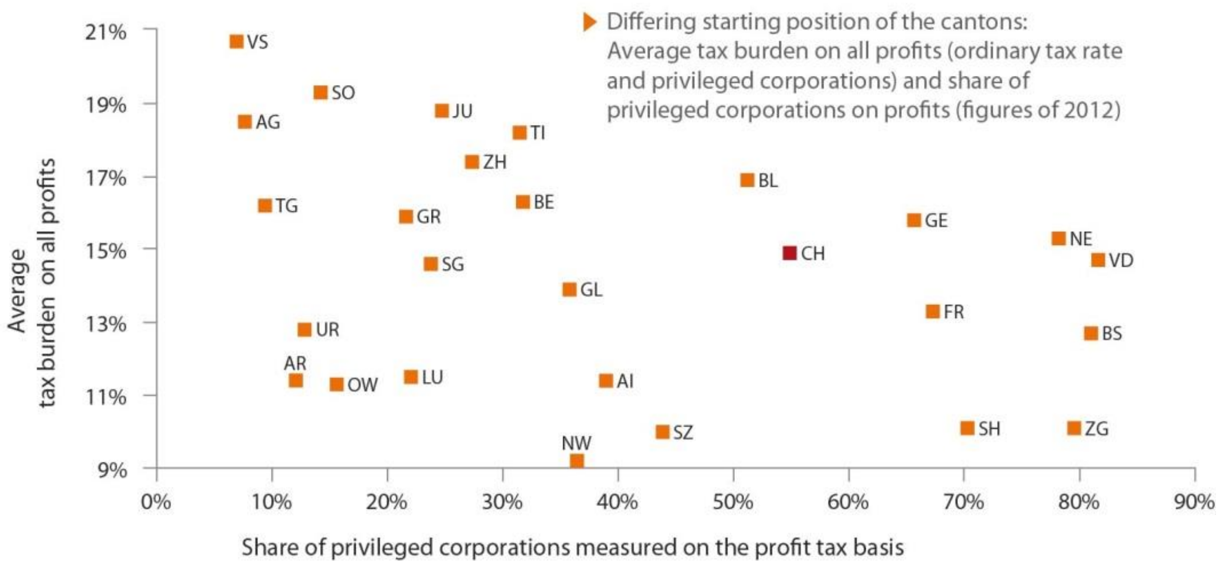
In Switzerland, approximately 24'000 international companies with a total of 135'000 to 175'000 employees are subject to special taxation regimes. These companies, often subsidiaries of foreign as well as many domestic corporations, have a large impact on the Swiss economy and the Swiss tax income. They are accountable for almost 50% of all private R&D expenses. A large number of Swiss small and medium-sized enterprises benefit indirectly from these companies via suppliers and service operations. Although they account for only about 7% of all companies, these corporations under special taxation regimes finance almost half of Switzerland's Federal profit tax revenues. In total, they pay approximately CHF 5,3 billion of profit taxes.

Due to these tax privileges, today's corporate tax regime of Switzerland is very attractive and ensures high tax revenues. International developments, however, require adjustments. Switzerland has committed itself towards the EU and the OECD to comply with international minimum standards. It is the aim of CTR III to achieve this goal. At the same time, the corporate tax system shall remain both attractive and profitable.

2. Who is affected?

Most affected of these changes are the Swiss cantons. The above mentioned special taxation regimes (or cantonal tax privileges) will be abolished. In order to keep their important tax payers (i.e. corporations), the cantons need to find a way to maintain an attractive fiscal regime. The starting positions of the various cantons are differing widely.

Differing starting positions of the various cantons



Quelle: Eidgenössische Finanzverwaltung (2015), eigene Berechnungen, NZZ (07.09.2016)
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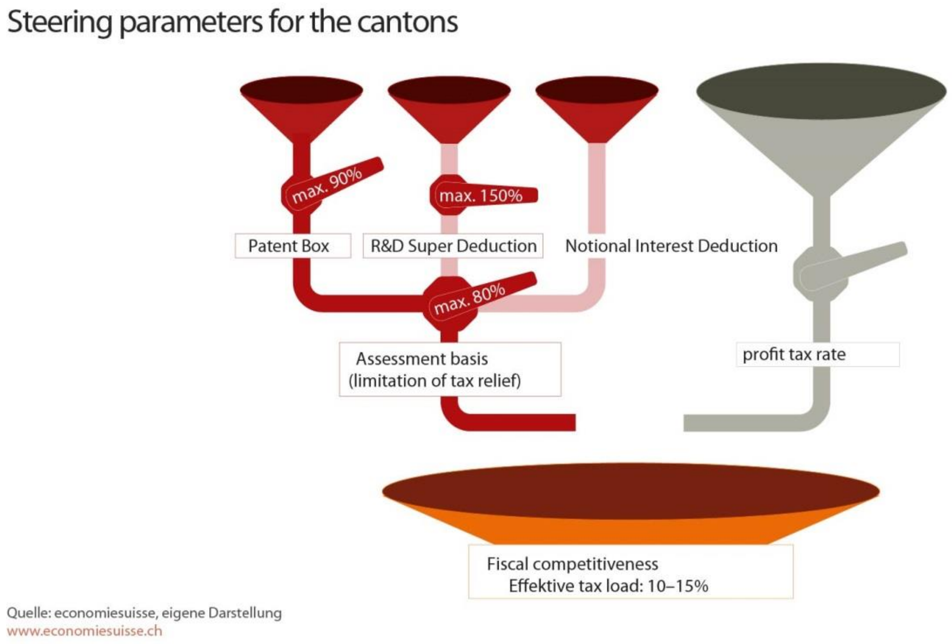
- In cantons with a large share of privileged corporations and high profit tax rate, these corporations will have to pay significantly more taxes when moving to ordinary taxation. These cantons have a potential for corporate profit tax reductions.
- Cantons that already have a low ordinary tax rate can maintain their attractiveness and they have little need for action.
- For cantons with a high tax rate but with an only small share of privileged corporations, profit tax reductions will prove costly, as only corporations charged with ordinary tax rates will benefit. These cantons will rely more on special tax solutions in order to limit a tax deficit.

3. What measures will be taken?

There will be no uniform solution for all the cantons – the starting positions differ too widely. Therefore the reform sees two directions of impact: First, cantons can apply new, internationally undisputed substitute regulations; second, they can reduce the profit tax rates to an internationally competitive level with financial support by the federal government.

As compensation for the previous special taxation regimes, cantons will be able to offer the following new measures:

- Patent Box (reduced taxation of income from patents and intellectual property)
- R&D Super Deduction (increased reduction for R&D expenses; e.g. for wages of researchers)
- Notional Interest Deduction (deduction of a deemed interest on excess equity) – Obligation to taxation of dividends of at least 60% if NID is introduced
- Reduced capital tax
- Step-up mechanism to reveal hidden reserves (to avoid later increase of taxation in case of transition to ordinary taxation)



Due to the fact that their starting positions differ widely, the cantons are entitled to adjust the measures of the CTR III to their needs by applying different steering parameters (diagram 2). These reductions are, however, limited. For tax relief related to the Patent box, there is a ceiling of 90 percent, for the facultative R&D Super Deduction the maximum relief is 150%. On top of that, the cantons are free to decide whether they want to apply the measure of the Notional Interest Deduction. The total relief based on these special regulations must not exceed 80%. (This relief is only applicable on the cantonal level, in addition, all corporations are subject to profits tax of 8,5% on the federal level). Cantons are entitled to tighten the restriction of the tax relief and instead to take measures regarding the profit tax rate. Also, a targeted mix of both tools is feasible. This is why the cantons support this reform.

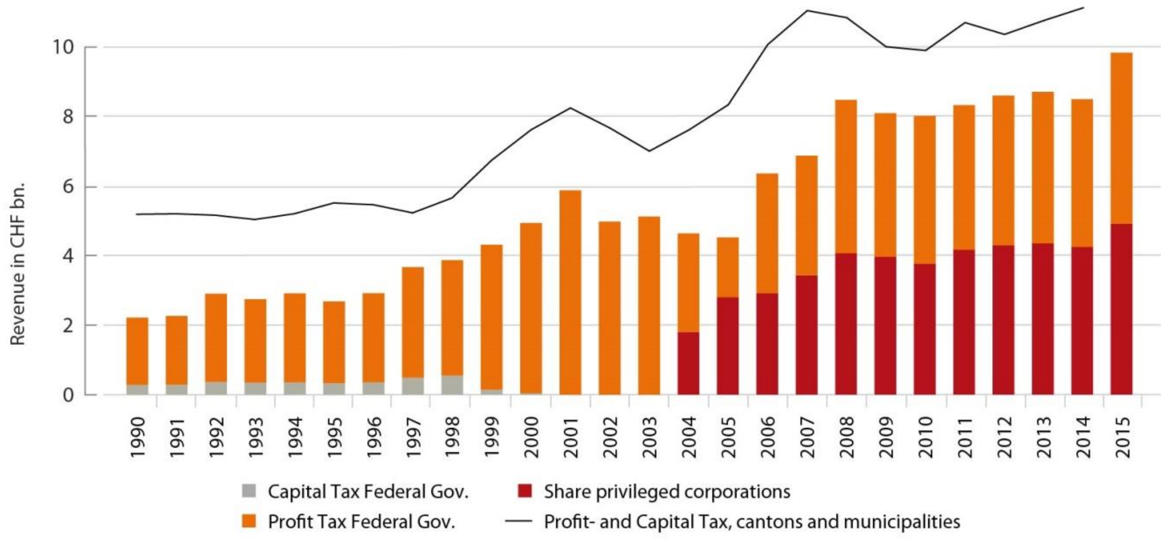
Currently, the cantons impose the direct federal tax on corporations on behalf of the federal government. 17% of these revenues remain with the cantons. In order to grant the cantons financial room for profit tax reduction, their share of the direct federal tax will be increased to 21,2 percent. Thus, every canton will receive compensation proportional to the federal tax revenues paid to the government.

4. What are the costs for the federal government?

The shortfall in revenues due to the introduction of CTR III for the federal government will be CHF 1,3 bn. The major share (CHF 1,1 bn) consists of the financial contribution of the federal government to the cantons. Since the federal government profits strongly from a fiscally attractive business location (diagram 3), it is legitimate that it contributes financially to the reform and to fund these expenses through the federal budget. CTR III has already been integrated in the forecast of revenues of the federal budget 2017 – 2019.

The only fiscal measure being introduced on the federal level is the Notional Interest Deduction. Statistically, this will cause CHF 222 Mio of shortfall in revenues. According to the Federal Council, the federal government would face a direct shortfall in revenues of CHF 236 Mio without this measure, due to emigration of financing activities that are currently under special taxation regimes. In consideration of the positive dynamic effects (companies moving in, stronger investment incentives) the Federal Council expects the measure to turn out to be profitable (Estimate of the results of the regulations implied by CTR III, section 6.3.3).

Federal tax revenue of Legal Persons (in CHF bn.) and share of privileged corporations known since 2004)



Quelle: Eidgenössische Finanzverwaltung (2016)
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5. What are the costs for cantons and municipalities?

As far as privileged corporations will be relieved by the new measures, the reform will not cause any tax deficits. Revenue shortfalls are to be expected in cases where corporations that have been subject to ordinary taxes will now profit from the new measures and the reduction of profits tax.

Depending on their starting position, the cantons will choose such strategies and instruments that suit their individual requirements best. Cantons such as Lucerne are already very attractive due to their low profits tax rate; they will not face additional costs. The canton of Vaud has already agreed on a reduction of the profits tax, which results in revenue shortfalls of CHF 392 mio (ordinarily taxed companies will pay CHF 442 mio less, while privileged corporations will pay CHF 50 mio more).

As per estimation by the Federal Council, the revenue shortfalls for cantons and municipalities will add up to a total of approx. CHF 2 bn. With the financial support of CHF 1 bn by the government, this financial burden will be equitably shared between the federal government, the cantons and the municipalities.

6. What would be the alternative?

Failing with the reform would cause severe economic damage and financial losses. Tax revenues of CHF 5,3 bn (profits tax alone) would be at stake. According to a current study, there would be further losses running into billions due to missing income taxes and missing indirect income (KPMG Swiss Tax Report 2016).

Even if the reform was to fail, the cantons would be compelled to take action, however without having the necessary fiscal and financial measures at their disposal. The obvious solution for cantons would be a reduction of the profits tax rate. The fiscal competition between cantons would become very fierce. Cantons might consider avoiding the tax harmonization law and autonomously installing special rules as emergency measures. The national cohesion with regards to the financial equalization would be severely at risk. Against this background, a rejection of the reform would be irresponsible.

If the Corporate Tax Reform III was to fail, a new attempt would be inevitable. The basic elements of the CTR III would have to be included in any new approach. The elimination of the special taxation regimes entails mandatory adaptations as far as the financial equalization between cantons is concerned in order to avoid severe distortions. The cantons would have to take on fiscal measures in order to retain important tax payers. Only special measures or a reduction of the profits tax rate could provide a solution.

7. Conclusion: What justifies the reform?

CTR III is a balanced and indispensable solution for Switzerland for the following reasons:

It is focusing on measures that are essential for the business location Switzerland

It avoids a massive fiscal deterioration that would cause severe economic and financial consequences for Switzerland

For the cantons, it opens up a fiscal and financial scope in order to implement an individual tax strategy

It ensures equal taxation rules for corporations and small and medium sized companies

The federal government can only profit from being an attractive business location, which justifies a financial contribution to the reform.