Clarity on Swiss Taxes

Corporate Tax Reform III
There is much at stake

May 2016


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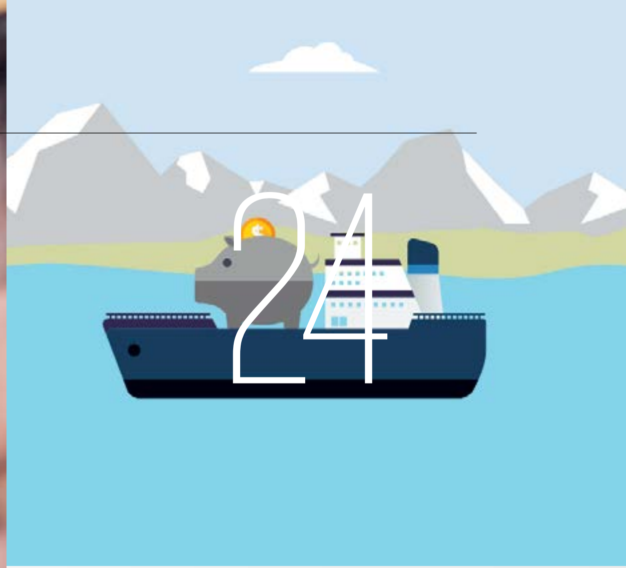
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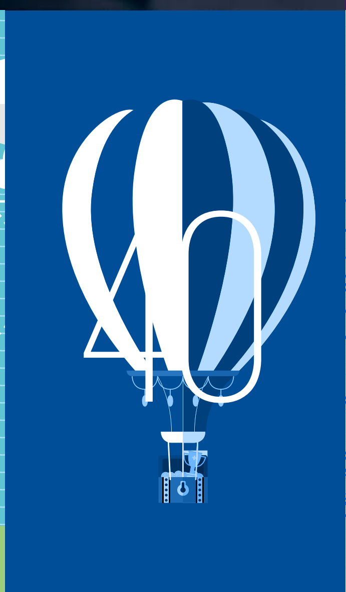
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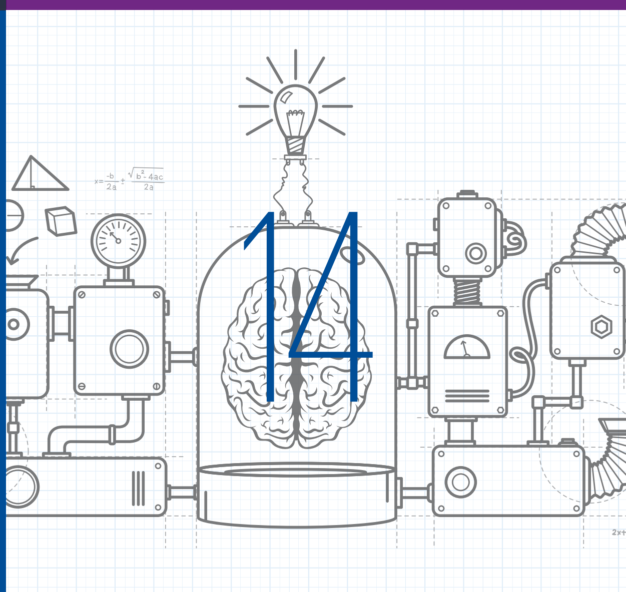
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How competitive is Switzerland?

EDITORIAL

Welcome

Peter Uebelhart
Head of Tax, KPMG Switzerland

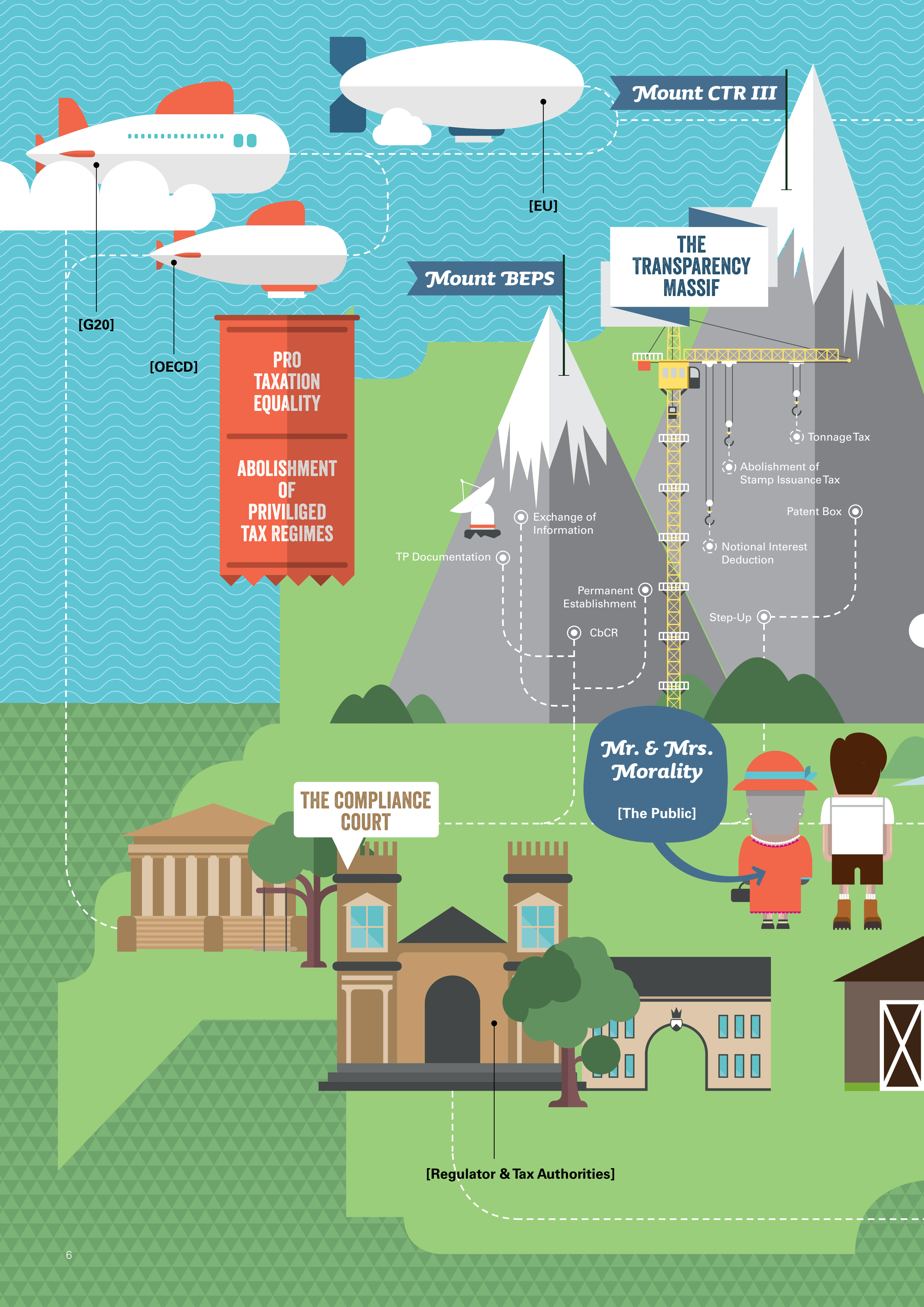
Switzerland remains near the top of international tax rankings. This is demonstrated by KPMG's "Swiss Tax Report 2016", which compares the corporate and personal income tax rates in 130 countries and all 26 Swiss cantons. International pressure is not diminishing, however, and it is of paramount importance for Switzerland to maintain its attractiveness as a tax and business location in the future with the Corporate Tax Reform III.

In the National Council's debate of March 2016, opinion was very much in favor of business-friendly measures and against additional tax burdens. The next step is for the draft legislation to go back to the Council of the States. From a corporate tax perspective, particular consideration will be given to the special deduction for foreign R&D expenditure and the tonnage tax. In "Clarity on Swiss Taxes" we therefore focus on these subjects and show what exactly they involve; we do so in part through conversation with renowned experts from the worlds of business, science and politics.

We would be happy to help you with any questions concerning the Corporate Tax Reform III and further international developments at EU, OECD and G20 level (e.g. the BEPS Action Plan) and look forward to advising you.

P. Ue

Peter Uebelhart



Mount CTR III
[EU]
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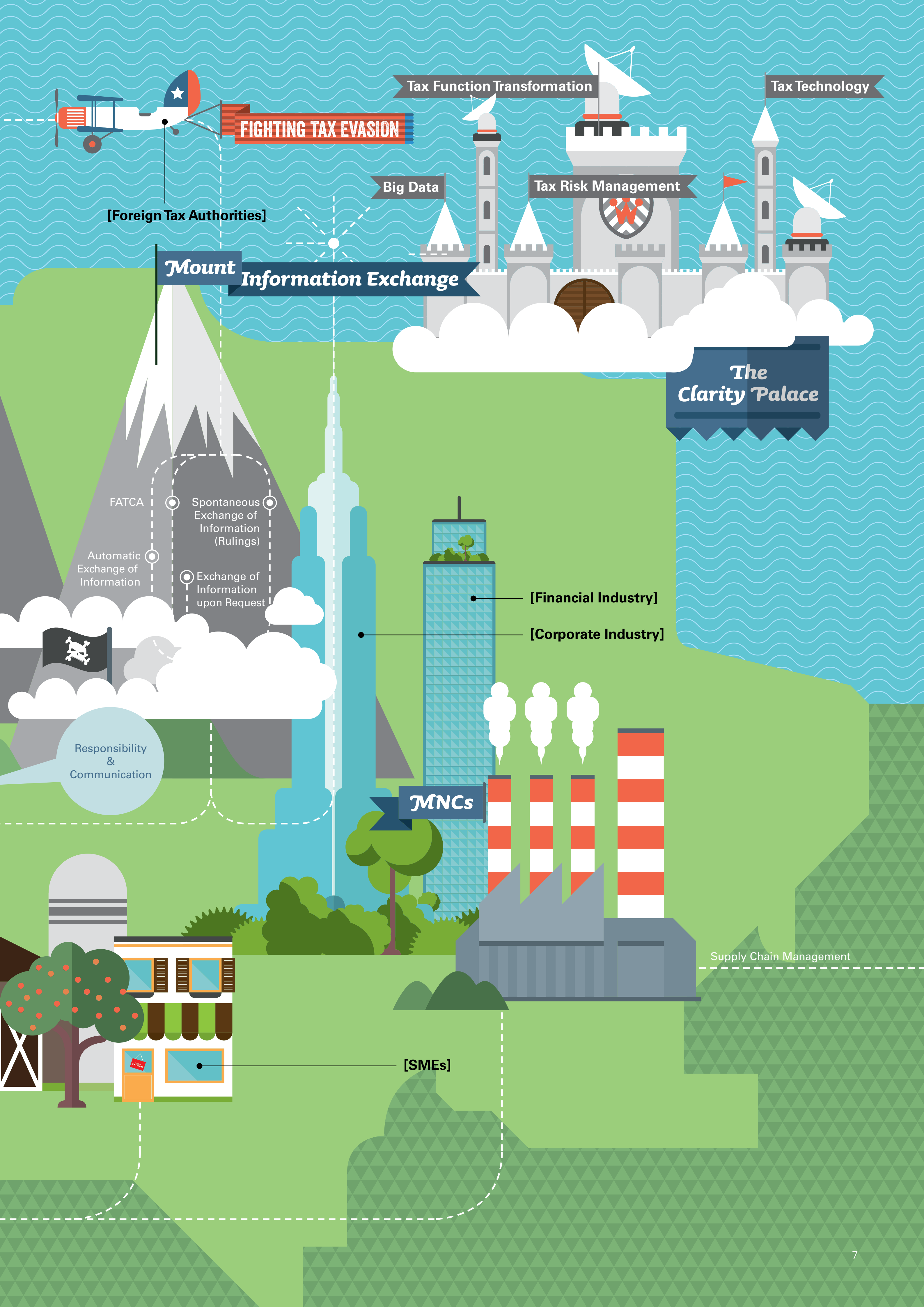
[OECD]
Mount BEPS
THE TRANSPARENCY MASSIF
PRO TAXATION EQUALITY
ABOLISHMENT OF PRIVILIGED TAX REGIMES
Tonnage Tax
Abolishment of Stamp Issuance Tax
Patent Box
Exchange of Information
Notional Interest Deduction
TP Documentation
Permanent Establishment
Step-Up
CbCR
Mr. & Mrs. Morality
[The Public]
THE COMPLIANCE COURT
[Regulator & Tax Authorities]


FIGHTING TAX EVASION
[Foreign Tax Authorities]
Tax Function Transformation
Tax Technology
Big Data
Tax Risk Management
Mount
Information Exchange
The Clarity Palace
FATCA
Spontaneous Exchange of Information (Rulings)
Automatic Exchange of Information
Exchange of Information upon Request
[Financial Industry]
[Corporate Industry]
Responsibility & Communication
MNCs
Supply Chain Management
[SMEs]

Tax incentives for R&D

The key to benefiting from CTR III

The Swiss federal government has reacted to increasing international pressure, especially from the EU and the OECD, by deciding to reshape Swiss tax legislation. In order to retain and further enhance Switzerland's attractiveness as a business location, the government has initiated the Corporate Tax Reform III (CTR III) which contains a strong focus on tax incentives for Research and Development (R&D).

Prof. Dr. Christoph A. Schaltegger, University of Lucerne, Christoph Huber, Head of Group Tax, OC Oerlikon Management AG; Dr. Frank Marty, Head of Tax Policy, economiesuisse, and Günter Schäuble, Head Corporate Finance and Tax, Schindler Management Ltd., discuss the necessity of CTR III and whether tax incentives for R&D will in fact lead to the desired outcome.

In conversation with **Stefan Kuhn,** Partner, Head of Corporate and M&A Tax, KPMG Switzerland

Stefan Kuhn *How important are taxes and incentives for R&D in deciding business location in general and for your company in particular?*
Christoph Huber Taxes are naturally an important component of any decision regarding location. However, it's not just a question of tax rates and the overall tax burden – it's also about how efficient, stable and reliable the tax system is. With regard to tax incentives for R&D, at OC Oerlikon – as at many companies – we view them as a positive. Although we have never taken a location decision on the basis of tax incentives alone, they are an important consideration.

Günter Schäuble Taxes are certainly a cost factor that influences business location decisions. However, much more important is to find where the brains and the markets are. We have R&D centers in the USA, Brazil, Austria, India and China as well as in Switzerland, for example. While all these countries offer attractive R&D incentives, to us it's actually more important that they are our big markets and the locations of our main customers.

I believe, therefore, that tax incentives for R&D are only interesting to a few companies. In practice, I expect the cantons will hesitate to introduce R&D input incentives due to the disadvantages it would create in Swiss revenue equalization. As the patent box will be narrow (definition of IP, nexus approach, tracking and tracing, Swiss entrance taxation), R&D incentives alone will not secure Switzerland's attractiveness. Long-term tax rate reductions will contribute much more to the country's appeal as a business location.

Kuhn *What else do we need to remain attractive as a business location?*
Huber There are obvious elements such as the availability of skilled labor and the existence of adequate infrastructure, of course. Beyond these, anything that reduces uncertainty tends to positively influence investment decisions. In this regard, a stable political system and reliable tax system are among Switzerland's assets, as is the possibility to engage with tax authorities.

Prof. Dr. Christoph A. Schaltegger For me, it's also a question of how attractive are opportunities outside of Switzerland. In my opinion, Switzerland is and will remain a very attractive location for companies looking for a highly skilled workforce, good infrastructure, political stability, legal certainty and so on. So the question is not "Should I stay or should I go?" but rather "Is there any place as favorable and as sustainable for business as Switzerland?".

Kuhn *Looking at the R&D environment, is it the only reasonable route to generating added value and what are your views on protecting intellectual property?*
Schaltegger We know that innovation results in profit. Economically, all corporate profits are the result of research that creates a temporary monopoly and hence pricing power for the innovator. If competitors sell the same product, produced in the same way, to the same customers, it will result in no profit. As basically all profits arise from innovation, therefore, it is difficult to defend special tax provisions for research, development or innovation. Possibly convincing is the argument that incentives to invest in research are too low overall due to spillover effects from innovation. As long as these spillovers cannot be privatized, the innovation level in an economy is too low. A special tax treatment could correct for this. However, a generally low level of taxes on profit combined with a working patent protection would increase incentives to innovate just as well – it would have a further advantage of increasing incentives for all kinds of innovation.

With respect to the definition of qualifying intellectual property rights, the OECD allows for a broad range of possibilities. Basically, everything that cannot be considered as marketing rights can be included in the patent box. Even special provisions are possible for small companies unable or unwilling to patent their innovations. The danger is one of significant administrative costs for the authorities, as someone needs to decide what is allowed in the box and what is not.

Huber Innovation is a key driver of Oerlikon's strategy. In fact, we invest 4% of our annual turnover into R&D. Many of our businesses are technology leaders in their markets and we work hard to maintain this position. It goes without saying that protection of intellectual property is an integral part of our strategy.

Kuhn *Can R&D promotion be seen as an economic mistake?*
Schaltegger As the R&D credit will be voluntary for the cantons and no such measure will be implemented at the federal level, the R&D credit will not be accounted for in the resource potential measure. The important point of the fiscal equalization system is that all cantons must be treated equally, meaning their resource potential must be determined using an identical method. If a canton does not introduce an R&D credit, there is no information available to account for this measure in the calculation of the resource potential measure. And since all cantons must be treated equally, the measure can't be accounted for in any canton. As a result, the fiscal equalization system will diminish the incentive to introduce such a measure.

However, the introduction of an R&D credit has an advantage for cantons compared to lowering general taxes on profit. As the measure is more selective – i.e. more concentrated on mobile and high-value-adding activities – there are less windfall gains for less mobile activities. You therefore gain more attractiveness for the same amount of revenue reduction.

"It's necessary that Switzerland offers R&D incentives if it is to be competitive in securing valuable corporate activities."

Christoph Huber
Head of Group Tax,
OC Oerlikon Management AG

Huber Countries have a macro-economic interest in attracting R&D, as such activities are a crucial element in the value chain. Tax incentives clearly influence location decisions as they have a positive impact on the cost of doing business. Many countries understand this and are offering various types of R&D incentives. It's necessary that Switzerland offers R&D incentives if it is to be competitive in securing valuable corporate activities.

Dr. Frank Marty In my opinion, whether one takes a view that it is positive or negative, R&D promotion is a political reality in Europe and abroad.

Kuhn *What is your view on the administrative workload and complexity relating to tax incentives?*
Marty Complexity will increase – in no small part due to new standards set by the OECD and the BEPS process. Less complex solutions like the ones provided by the current Swiss regimes are no longer tolerated. Businesses, as well as governments, must decide whether they want to continue applying special tax incentives such as patent boxes or push forward towards simpler tax systems with broad bases and attractive, competitive corporate tax rates.

Schaltegger I agree. With CTR III the tax system will get certainly more complex with all the pros and cons on the administrative burden and for tax consultants finding new loopholes. An important question is the impact of the fiscal equalization system on CTR III's incentives for cantons to implement innovative and attractive measures. In essence, the fiscal equalization system will reduce the competitive pressure for cantons and will make tax innovation more expensive and thus less attractive. CTR III improves this somewhat. It introduces so-called zeta factors for profits in general and for profits within the patent box in particular. The notional interest deduction will also be accounted for in the system. Due to the reduced weighting of these profits within the measure that determines a canton's resources or "richness", it will be more profitable for cantons to attract companies. Compare that to today, when it is much more profitable for cantons to attract rich households, as their income can be taxed considerably higher than company profits.

Kuhn *How much will the administrative burden of cantons increase?*
Marty It will increase not only due to CTR III but more importantly due to the new standards set by the OECD (exchange of rulings, country-by-country reporting). By how much the administrative burden grows will depend on how many companies will use new instruments such as patent boxes, R&D promotion or, eventually, the notional interest deduction. Cantons that favor a competitive tax rate (rather than new special regimes) might be able to reduce their administrative burden.

"We need this reform and we need it now."

Dr. Frank Marty
Head of Tax Policy,
economiesuisse

"Besides taxes, it is much more important where the brains and the markets are."

Günter Schäuble
Head Corporate Finance and Tax,
Schindler Management Ltd

"There is no economic rationale for the Corporate Tax Reform III; it's about compliance with international 'soft law'."

Prof. Dr. Christoph A. Schaltegger
University of Lucerne

Kuhn *Put simply, do we need CTR III?*
Schaltegger In my view, there is no economic rationale for CTR III: it's about compliance with international "soft law". The Swiss preferential taxation regime – particularly the special rules on foreign profits, which are by definition mobile, has proved to be very efficient, revenue generating and globally attractive. It reduces competitive pressures to lower tax rates for less mobile activities, thereby avoiding ruinous tax competition or a 'race to the bottom'. CTR III is a reform aimed at securing the EU and OECD's political acceptance of the Swiss tax system, as these organizations accuse Switzerland of tax-based distortive subsidies that undermine the 1972 Free Trade Agreement. Of course, Switzerland cannot ignore these accusations due to the dependence of any small open economy on good relations with its main trading partners.

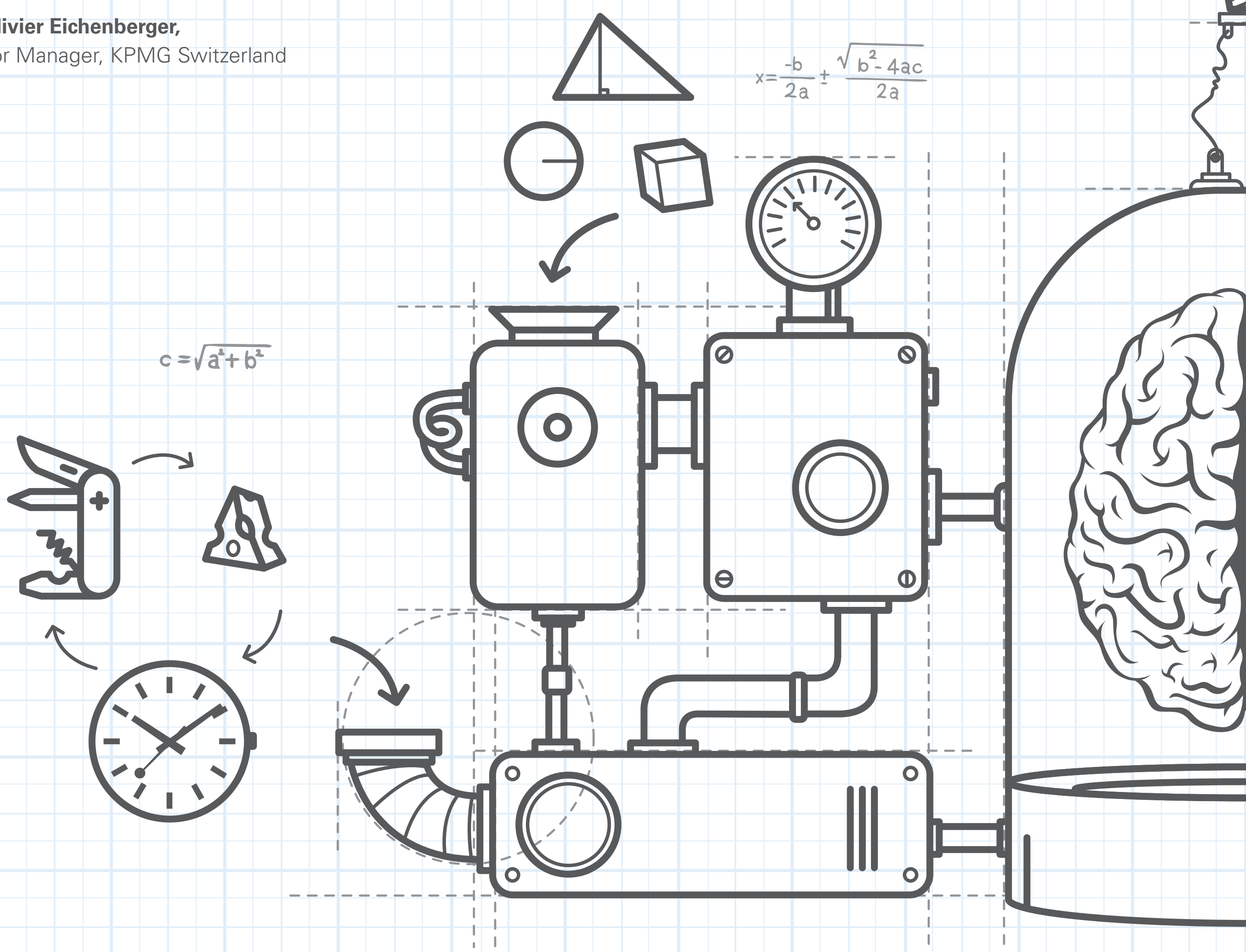
Marty I disagree that there is no economic rationale for CTR III. I am absolutely convinced that we need this reform and we need it now to make sure Switzerland remains fiscally attractive to international business in the long term. economiesuisse's clear focus is on a tax reform that is both attractive to business and in line with international standards. There is no alternative to CTR III. Even if the present CTR III fails, many of its principal elements will have to be implemented anyway. These include the abolition of current special regimes, adaptation of the fiscal equalization scheme, federal support for cantons, the introduction of patent boxes and the reduction of capital tax. Without CTR III, harmonization of tax bases between cantons might fall. With CTR III, there will also be more diversity, but this diversity will be based on a common law. By contrast, a reduction in the level of harmonization as a result of a failed CTR III will be arbitrary. Tax competition within Switzerland would rise.

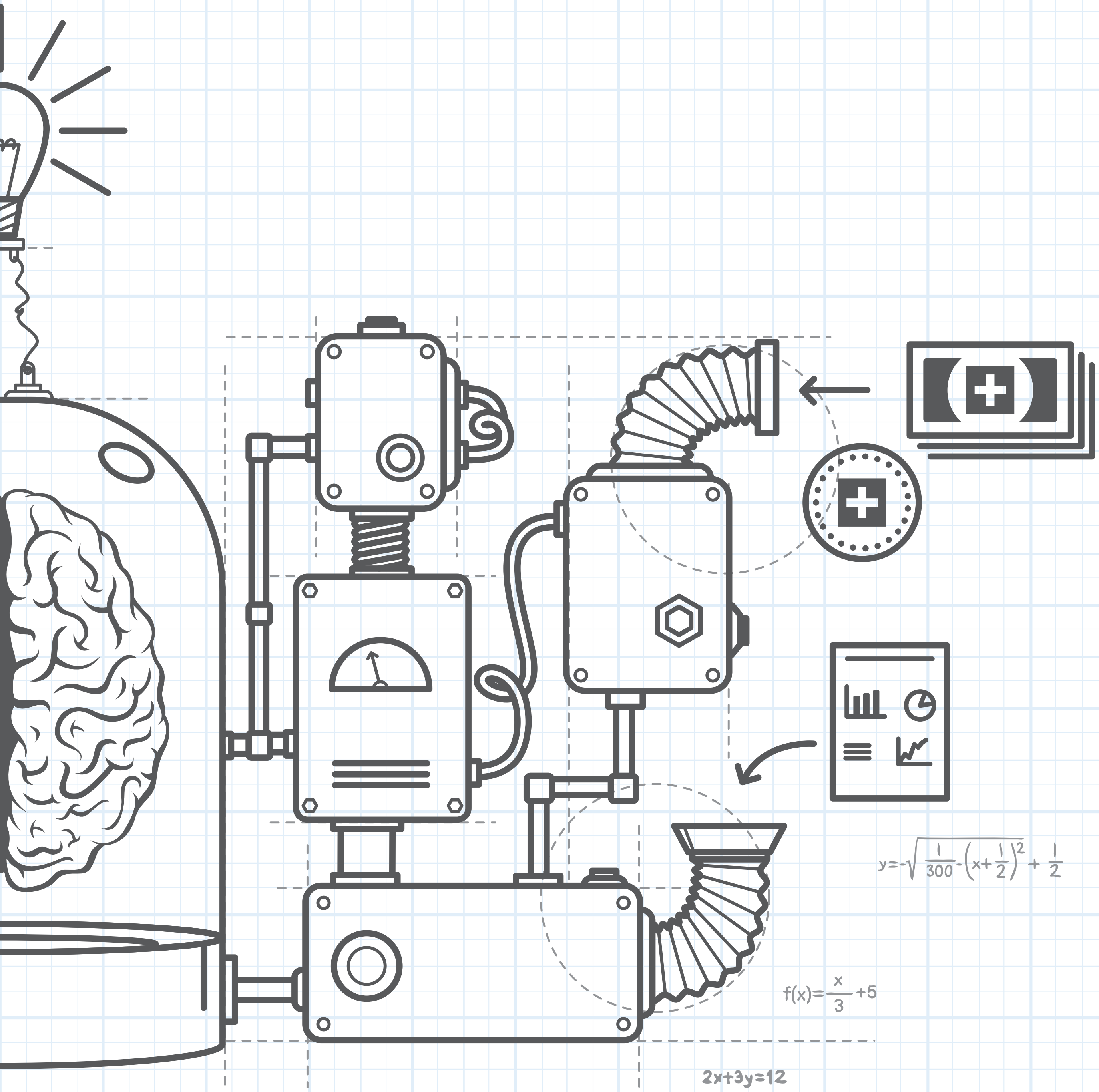
Huber I am strongly of the opinion that the Swiss government's promise to initiate CTR III has already had a very positive effect. For a few years now, we've seen Swiss-based companies put under heavy pressure by many other countries and supranational organizations. The BEPS project is one example that is resulting in an additional compliance burden and higher costs. With the introduction of CTR III, I believe countries are acknowledging that the Swiss tax system is returning to international best practice. This is a good thing and it is crucial to deliver on our commitment to CTR III.

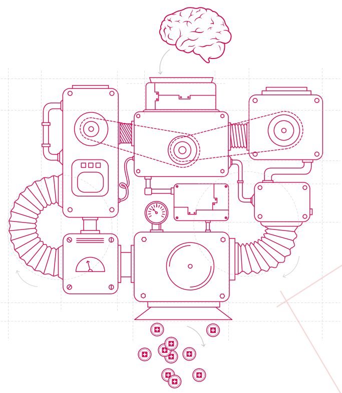
Fiscal incentives for input into research and development

How does Switzerland compare to other countries?

By Olivier Eichenberger,
Senior Manager, KPMG Switzerland




$y=-\sqrt{\frac{1}{300}-\left(x+\frac{1}{2}\right)^2}+\frac{1}{2}$
$f(x)=\frac{x}{3}+5$
$2x+3y=12$



Definition of Research and (experimental) Development (R&D) according to the OECD's Frascati Manual

R&D comprises creative and systematic work undertaken in order to increase the stock of knowledge – including knowledge of humankind, culture and society – and to devise new applications of available knowledge. In order to qualify as R&D, the nature of the activity must be as follows (five criteria):

Novel
To obtain new knowledge /new insights / new product, compared with the existing position

Creative
The R&D must comprise a new concept/idea that improves on existing knowledge, i.e. not routine activities, but development of methods to optimize these

Uncertain
Uncertainty about costs/time needed to reach the goals and as to whether its objectives can be reached at all

Systematic
Consistent recording/documentation of the results and of the process of R&D

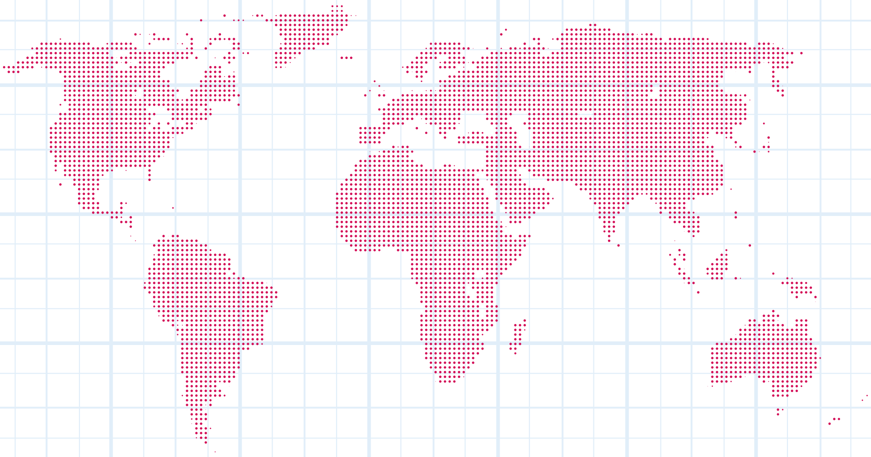
Transferable and/or reproducible
Transferability or fungibility of new knowledge / results

CTR III includes some internationally accepted R&D promotional measures. These are on the one hand the output-based patent box and on the other hand the (optional) input-based super-deduction for R&D expenditure which applies to the tax base. This last measure should be distinguished from a reduction of the tax liability (tax credit).

In connection with the super-deduction, the cantons will probably enjoy some leeway when defining the qualifying R&D and the permitted amount. The Council of the States decided in December 2015 to limit the deduction to a maximum of 150% of actual costs. The National Council, however, envisages a limitation on the total tax relief from the patent box, interest-adjusted profit tax and super-deduction for R&D expenditure of 80% (the cantons may determine a different percentage quota) of taxable profit before these deductions, set-off of losses and excluding qualifying participation income. In April 2016 the responsible commission of the Council of the States basically accepted such a solution. In order to avoid double incentives, in the case of contract R&D it is envisaged that only the person actually commissioning the research should be able to apply the higher deduction; and further, in the event of losses, that it should not be possible to pay out the value of the incentive. There is also still a discussion as to whether the location of the relevant R&D should be restricted to Switzerland, as the National Council (by contrast with the Council of the States) wants to cover contract R&D by third parties outside Switzerland. Although according to the Federal Council and the National Council it should be left to the cantons to define the qualifying R&D, the dispatch of 5 June 2015 pointed to the OECD's Frascati Manual, which contains a definition of R&D (see page 16).
Looking beyond Switzerland's borders, it becomes clear that both our neighbors and countries that are characterized by their economic competitiveness have already introduced comprehensive measures for the fiscal promotion of input into R&D (see table on page 18/19). These countries predominantly use the super-deduction and tax credits as the main element of their incentive systems. In addition, there is sometimes the possibility of temporary exemption from certain tax liabilities or of accelerated depreciation of R&D facilities. In view of the current discussion in connection with CTR III, special attention should be given to the scale of these countries' super-deductions. In the majority of cases the deduction is somewhere around 150% and 200%, and can be claimed at national and/or provincial level (depending on the respective tax system). As the super-deduction is only to be introduced at cantonal level in Switzerland, it ought in principle to be set at a higher percentage in order to achieve a comparable effect to the deductions in these other countries (regardless of differences in the general tax burden). In addition, comparing these countries shows that a combination of fiscal promotion for R&D input and for R&D output is not only possible, but also perfectly usual (e.g. the Netherlands, Italy, the UK).

Conclusion

In conclusion it can be stated that the super-deduction in respect of R&D expenditure envisaged for Switzerland (optional and limited to cantonal level) is in the lower range compared with other countries – particularly if it were to be limited to 150% in accordance with the Council of the States' decision. This deduction should, however, still have a positive effect on Switzerland as a location for innovation and on the retention of existing and new R&D activities (in particular due to the combination with, or the addition of, the patent box, even if the same R&D activities cannot benefit from both promotional measures). An extension of the super-deduction to contract R&D by third parties outside Switzerland would facilitate the involvement of foreign universities and institutes in R&D activities. This could help prevent a possible emigration of businesses and/or further increase the attractiveness of Switzerland to potential new innovative businesses.



Legend

A] IP box / patent box / innovation box / knowledge development box

B] Tax holiday resulting from an R&D-related tax status

C] Tax exemption / tax reduction (not only profit tax) due to R&D activities

D] Accelerated depreciation on R&D assets

E] Reduced tax rates resulting from an R&D-related tax status

Comments

1] Countries will mainly be specified that are located geographically close to Switzerland or actively support tax incentives for R&D (it is a non-exhaustive list). As Germany conducts R&D support by assigning grants and not via a system of tax incentives, it has not been included in the table.

2] The percentages indicated concern tax incentives at a national and/or subnational level.

3] Country-specific requirements for the qualification of R&D occurring abroad remain reserved. R&D taking place abroad should be checked in case contracted R&D activities could be conducted by a related group company or by a third party in order to qualify for the deduction.

4] To benefit from these measures companies must be granted ATSE (Advanced Technology Service Enterprise) or HNTE (High and New Technology Enterprise) status.

5] This super-deduction is only granted to young R&D companies (Jeune Entreprise Innovante).

6] The percentage of the deductibility depends on the specific kind of R&D expenditure/activity (e.g. 200% for in-house R&D).

7] Exception: The country in which R&D activity takes place already permits a corresponding tax deduction for such expenditure.

8] Legge di Stabilità 2015, Art. 7: 25-50% is in relation to the annual R&D expenditure that exceeds the annual average of the previous three years. The annual tax credit is limited to EUR 5 million per recipient and R&D expenditure must amount to at least EUR 30,000.

9] It is proposed to limit the super-deduction (Council of States) to 150% or to cap the total tax deduction resulting from the discussed super-deduction, patent box and notional interest deduction at 80% of the taxable profit (before such deductions and offsetting loss carryforwards and under exclusion from participation income) (National Council).

10] The definition of SME can vary from country to country.

Input tax incentive for R&D

Country[1]	Super-deduction	Tax credit
Austria		X
Canada		X
China	X	
Czech Republic	X	
France		X
India	X	
Ireland		X
Italy		X
The Netherlands		X
Switzerland	[X]	
Singapore	X	
UK	X	X
USA		X

Description[2]	Place of qualifying R&D activities[3]	Further tax incentives
10% tax credit on qualifying R&D expenditure	EU/EEA	
15% federal tax credit on qualifying R&D expenditure Small Canadian-Controlled Private Corporations (CCPCs) can claim a 35% investment tax credit; this tax credit is limited to CAD 3 million At the provincial level, further tax credits can be claimed ranging between 4.5 and 37% of the qualifying R&D-related expenditure	Within the country	D]
150% super-deduction of qualifying R&D expenditure	Within the country	B][4], C][4], D][4], E][4]
200-210% super-deduction of qualifying R&D expenditure	Within the country as well as abroad	B]
30% tax credit on the first EUR 100 million R&D expenditure and a 5% tax credit on R&D expenditure above this threshold	EU/EEA	A], B][5], D]
Until 31 March 2017: 100-200%[6] super-deduction of qualifying R&D expenditure With effect from 1 April 2017: maximum 150% super-deduction of qualifying R&D expenditure	Within the country	A] (presumably from 1.4.2018), B], C], D], E]
Since 1 January 2015: 25% volume-based tax credit on qualifying R&D expenditure (if a group of related companies exists, the tax credit can be claimed at group level) Separate 25% tax credit on expenditure incurred on constructing or refurbishing R&D facilities	EU/EEA[7]	A], D]
Since 1 January 2015: 25-50% incremental tax credit on qualifying R&D expenditure[8] A 35% tax credit can be claimed for amounts paid to qualified researchers hired during the 2013 and 2014 fiscal years Immediate deduction of 20% of the investments by corporations in R&D-Intensive Start-up Companies (IST) during the years 2014 to 2016	Within the country	A]
Since 1 January 2016: 32-40% tax credit on the first EUR 350,000 of qualifying R&D expenditure and 16% on all further R&D expenditure; the benefits resulting from this tax credit will be awarded in the form of a wage tax reduction and are limited to the amount of the wage tax	EU	A], C]
Current proposal: super-deduction of qualifying R&D expenditure at cantonal level (optional; percentage can be determined by the individual canton)[9]	Within the country/ possibly abroad	A]
In general: 100-150% (super)-deduction of all qualifying R&D expenditure Companies granted "Productivity and Innovation Credit" (PIC) status: additional 250-300% enhanced deduction of the first SGD 400,000 of qualifying R&D expenditure and for SMEs[10] of the first SGD 600,000 (total deduction resulting from PIC status and general [super]-deduction is limited to 400%) Specific R&D expenditure incurred relating to R&D projects approved by the government can be deducted at a rate of 50% in addition to the general (super)-deduction (but cannot be combined with the super-deduction resulting from PIC status)	In general: within the country Companies granted PIC status: R&D expenditure incurred in the country and abroad	
230% super-deduction of qualifying R&D expenditure for SMEs[10] until the tax benefits resulting from this super-deduction exceed by EUR 7.5 million the tax benefit the SME would have received if it were not an SME 130% super-deduction of qualifying R&D expenditure for companies of all other sizes (as an alternative to the tax credit mentioned below; only possible until 31 March 2016) 11% tax credit on qualifying R&D expenditure for companies of all other sizes	Within the country as well as abroad	A], D]
Effective tax credit amounts to a maximum of 9.1% of the annual qualifying R&D expenditure	Within the country	D]

CTR III now entering the final lap

by Prof. Dr. Christoph A. Schaltegger
University of Lucerne and Institute of Public Finance and Fiscal Law IFF of the University of St. Gallen

Something that started in February 2007 is now nearing its end. At that time the European Commission reprimanded Switzerland for its selective tax incentives in the area of holding, mixed and domicile companies as being a breach of the Free Trade Agreement of 1972. The tax rules represented unjustified state aid – so ran the argument. Switzerland fought this accusation with arguments about the principles involved. If anyone expected, however, that the best legal and economic arguments would win the day, they underestimated the strength of "soft law". Switzerland soon realized that this was not a technical tax matter, but more of a political question. Politics concerned with power and economic interests.

Dual strategy of the Federal Council

Switzerland had to recognize the truth of this. Doing nothing is not a realistic option for a country with a small and outward-looking economy: For a location with numerous international companies, the risks associated with international condemnation would be considerable. If international cooperation were to be refused in fiscal matters, such as in connection with double tax treaties, that might seriously harm Switzerland as a business location. It is therefore easy to understand why the Federal Council has suggested a dual strategy to Parliament.

The dual strategy means specifically: firstly, changes to the tax system by using selective tax incentives that are internationally accepted and which reduce the tax base for corporate tax. Secondly, reducing ordinary corporate tax rates so that the difference with tax rates for currently privileged companies is reduced. This dual strategy minimizes the risks, because both low ordinary tax rates and selective tax incentives still need to be politically accepted by the OECD or the EU. The use of various measures will reduce the political risk with regard to future decisions by international organizations which determine "soft law".

At the same time, it is important to be aware that the ever-changing EU case law necessitates a certain flexibility that would allow the rules for the new selective tax incentives to be amended in the future. Certain replacement measures under discussion – in the areas of patent boxes, special deductions for research and development expenses and the flat-rate tonnage tax for shipping companies – are currently common instruments in many countries. It is not clear, however, for how long and to what extent these special rules will be tolerated at an international level. It is difficult to see the logic of the discussions on the limitations of the tax base from a technical tax point of view, and even with CTR III, legal certainty is by no means assured. The situation is rather different for other suggested measures such as the notional interest deduction and the reduction of the ordinary tax rate. The first of these measures can improve the so-called financing neutrality; the acceptance of this measure should also be preferred because it limits a factor that leads to distortions, namely the fiscal incentive for debt financing. Under the second measure there is no differentiation whatsoever between different kinds of corporate income.

Problematic increase of the cantonal share

While the federal government is amending the selective tax incentives according to the dual strategy in the areas over which it has authority – namely in the framework law for cantonal tax, the Tax Harmonization Act, and partly in the Direct Federal Tax Act – it will leave the application of these incentives, as well as the reduction of the ordinary tax rate, to the cantonal governments. The federal government assumes that the cantons will cut their corporate tax rates, which currently average a little under 22%, to around 16%, in order to optimize the amount of corporate tax revenue. In order to give the cantonal governments more room for fiscal maneuver, the federal government is considering increasing the cantons' share of revenue from direct federal tax, from 17 to 20.5% – the cantons are even demanding an increase to 21.2%. Thus, revenue of about CHF 770 million to CHF 920 million will be shifted from the federal government to the cantons. The proportion of their revenue which the cantons can determine themselves, autonomously, will thus shrink, and their financial autonomy will suffer. Economic experience has shown that this result is unfortunately likely to work against the Federal Council's objective. Non autonomously levied funds tend to be used for an increase of public spending and are seldom deployed for improving the fiscal attractiveness of locations for businesses.

Avoid a "community of liability" between the federal government and the cantons

CTR III envisages a general solution of a shared responsibility: Half of the costs of compensating for loss of revenue should be borne by the federal government, half at cantonal level. The creation of a community of liability between the federal government and the cantons will blur responsibilities and therefore give rise to problems at various levels. Firstly, the logic of compensation will increase the complexity of the tax system and the system of transfer of funds. Secondly, there will be a move away from the principle of fiscal equivalence, currently applied under the so-called National Fiscal Equalization ("Neuer Finanzausgleich, NFA") between the various cantons – liability, risks and control over the tax strategy will be pooled between the cantons and the federal government. Thirdly, the new sharing of revenue will trigger further wishes, because every tax reform in the area of corporate tax affects all levels of government and may thus appear deserving of compensation. The compensation gives rise to the danger of a moral hazard: As they are expecting future compensation payments in connection with tax reforms, the cantons will develop their tax strategy in a less responsible way, due to the existing precedent. In addition, CTR III envisages amendments in the equalization of resources under the NFA. On the one hand, corporate profits will, rightly, be weighted differently when calculating the index of resources (the so-called zeta factors); on the other hand, at least temporarily, a nominal minimum funding will be introduced. If it is not possible to finance this minimum funding, money from the so-called compensation for hardship will go to the cantons that are the weakest in resources, to lift them up to above the nominal goal. The amendments in connection with the equalization of resources are alarming. For one thing, a nominal minimum funding is diametrically opposed to the NFA's relative equalization goal of 85%. For another thing, a further moral hazard arises: Compensation will also be expected in the case of future reforms. This will weaken independent action by the cantons accordingly. Continuing to use funds from the compensation for hardship is also questionable: It is generally accepted that the compensation for hardship represents an element which is alien to the NFA system and which ought to be abolished after a transitional phase.

Conclusion: CTR III is both good and bad news

The CTR III reform presents Switzerland with a threefold challenge: firstly, the improvement of its international fiscal conformity; secondly, the maintenance of its attractiveness as a business location; and thirdly, securing income for the public budgets. In a difficult political environment, the Federal Council's dual strategy for CTR III is pragmatic and constructive: changes to the selective tax incentives and simultaneous reduction in the ordinary corporate tax rate in order to reduce the difference in the tax burden for privileged income and ordinary income. The Federal Council has unfortunately not properly assumed responsibility for improving Switzerland's fiscal attractiveness as a business location. If corporate tax were reduced at federal level, liability, control and risks would remain mainly with the federal government. At the same time, the federal government would give the cantons room to maneuver, which the cantons would be able to use according to their own fiscal position. The revenue sharing of cantons and federal government would thus not increase – sustainability at the level of the cantons would also be strengthened. The NFA principle of fiscal equivalence would be retained.

Tonnage tax: A missed opportunity

By Stefan Kuhn
Partner, Head of Corporate and M&A Tax, KPMG Switzerland

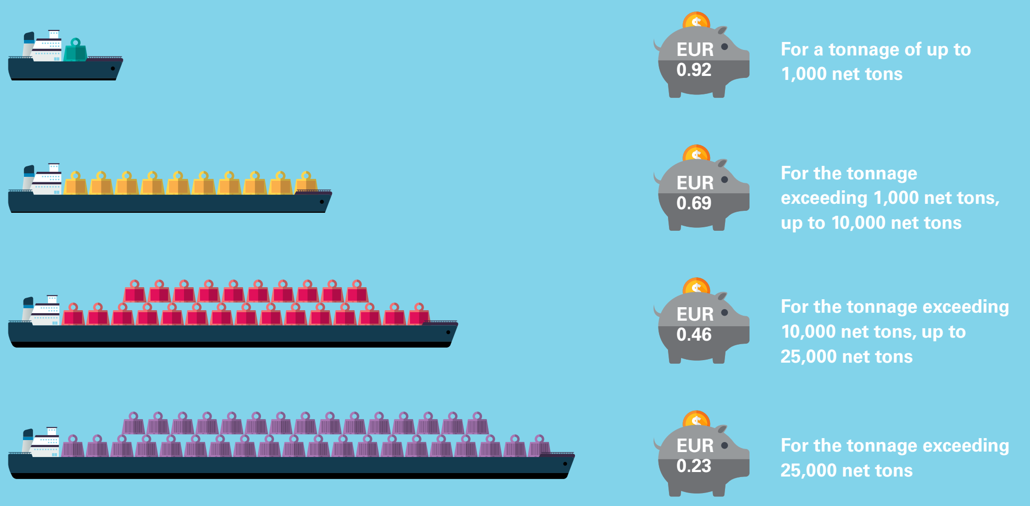
During the last few years, exponents from the shipping industry have suggested the possibility of introducing a tonnage tax in connection with the Swiss Corporate Tax Reform III (CTR III). Without giving reasons for the omission, however, the Federal Council has not included this tax in the draft for CTR III legislation dated 5 June 2015. During January 2016's discussions in the Economic Affairs and Taxation Committee of the National Council of Parliament, the committee pronounced itself in favor of the introduction of a tonnage tax. The corresponding committee of the Council of the States wants the Federal Council to look again at the possible introduction of a tonnage tax and to submit it separately from CTR III. So, what exactly is this tonnage tax?

Principles of a tonnage tax

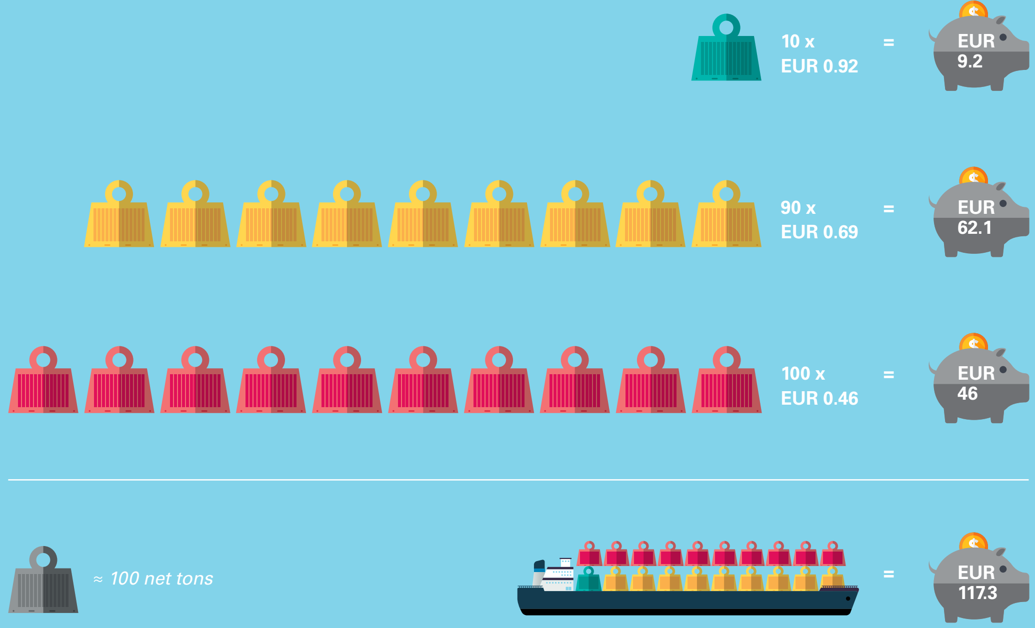
It must first be said that a tonnage tax is not a separate tax. Shipping companies would continue to be subject to corporate income tax directly at the federal tax level and at the cantonal/communal tax level. The difference lies in the method of determining the profit for tax purposes. Instead of the actual profit or loss, the taxable profit is determined as a standardized amount according to a ship's cargo space capacity (net tonnage).

Various countries which levy tonnage tax pursue slightly different models for determining shipping companies' profits. An example according to § 5a of the German Income Tax Act is shown below, which illustrates how profit can be determined for merchant ships used in international transport.

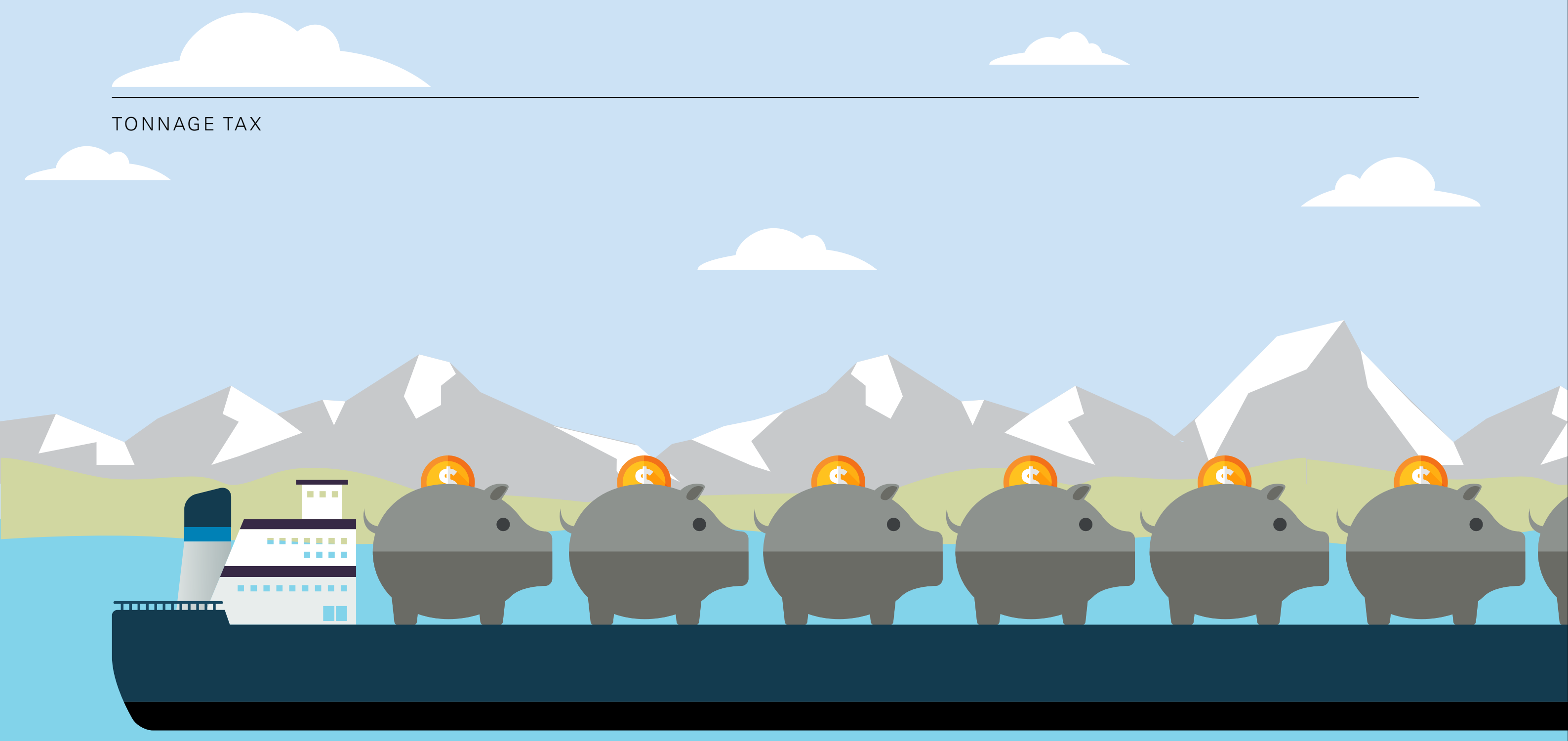
The profit realized during the business year is calculated for each merchant ship operating in international transport as an amount per day of operation for each full 100 net tons (net tonnage) respectively:



In the case of a ship with a net tonnage of 20,000 tons, this results in the following profit for each day of operation:



Assuming that there are 365 days of operation, the resulting taxable profit is EUR 42,814.50.



It is thus quite possible that the effective tax rate can be a single-digit percentage. The snag is that the company still has to pay corporate income tax even when its statutory accounts show a loss.

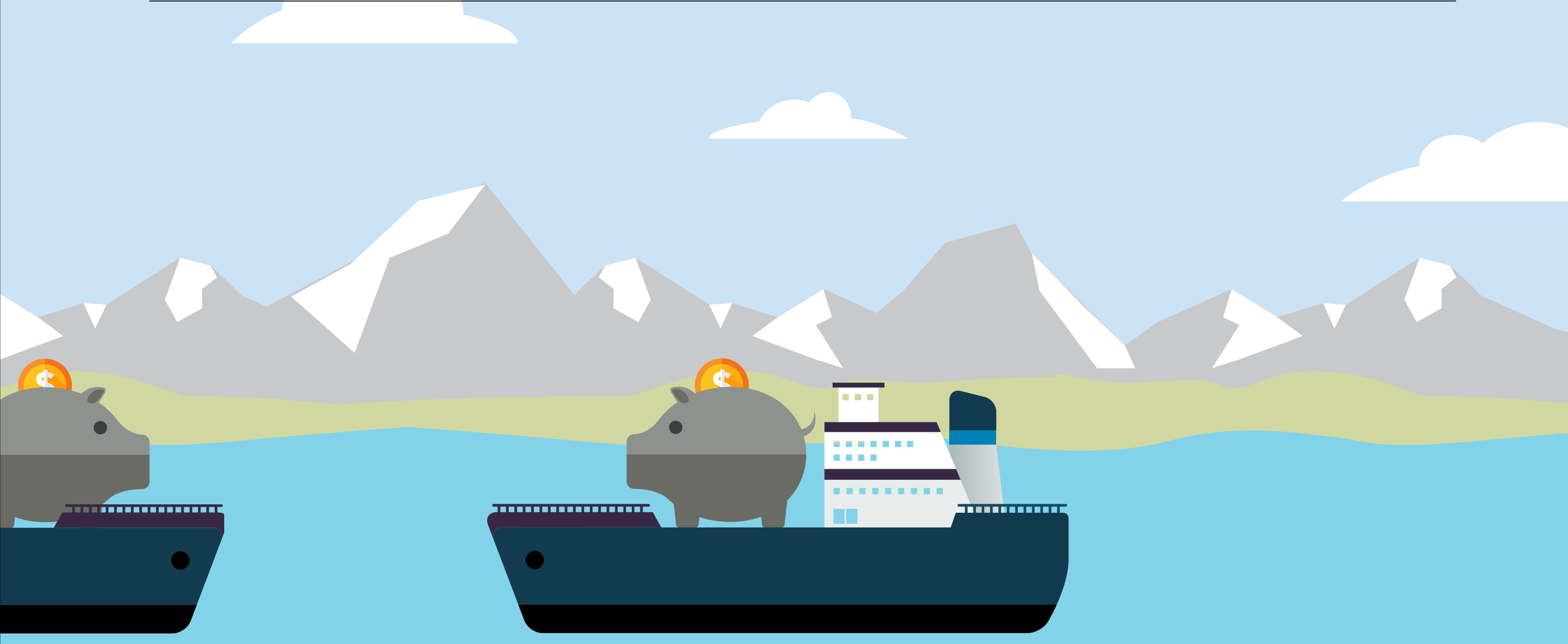
International acceptance

Both within the EU (e.g. in Belgium, Denmark, Germany, the UK, Finland, France, Greece, Ireland, the Netherlands and Spain) and in some other industrialized countries (e.g. the USA and Singapore), tonnage tax is a recognized model for determining profit for the maritime shipping industry. The EU commission indicated as early as 1997 and then in 2003 through the issue of new Guidelines (see http://europa.eu/rapid/press-release_IP-03-1484_en.htm?locale=en) that it supports the tonnage tax model. This was reaffirmed after a thorough review in the years 2012/13. The introduction of a tonnage tax would thus be very much in keeping with CTR III, which wants to abolish current tax privileges on the one hand, but on the other hand retain Switzerland's attractiveness as a business location by taking into consideration the tax conditions supported by the EU and the OECD.

Why a tonnage tax?

According to the Federal Department of Finance's (FDF) Questions and Answers document of 5 June 2015 on CTR III, it appears that the introduction of a tonnage tax would not be in line with constitutional law provisions. The FDF does not state exactly which specific provisions are meant here. An expert opinion from Prof. Robert Danon was the deciding factor – however he still sees an open door here now that most industrialized countries that have a tonnage tax regard this method of determining the profits as absolutely compatible with their constitutions.

Maritime shipping companies regard themselves as intrinsically exposed to international competition. If it is not only typical offshore locations, but also the big industrialized countries that have a tonnage tax or other tax advantages for maritime shipping companies, then Switzerland should take action to establish a "level playing field" to keep this industry in Switzerland or to entice it here. Even if shipping companies are a relatively small industrial sector in our landlocked country, it is interesting to note that Switzerland has been able to establish itself as a logistics center over recent decades. Well-known companies knew how to position themselves as internationally important. As is also generally known, Switzerland is a center for trading in commodities and raw materials, as well as for the financial services industry and insurance. The synergies with all these industries and the maritime shipping industries are unmistakable. The conclusion is therefore obvious that Switzerland does indeed have great potential for attracting shipping companies – provided it offers them the same tax conditions as other industrialized countries.
Tonnage tax also has the advantage that it generates a predictable annual tax revenue.



Conclusion

Tonnage tax is an appropriate tool for attracting the establishment of maritime shipping companies in Switzerland, along with complementary and ancillary economic activities.

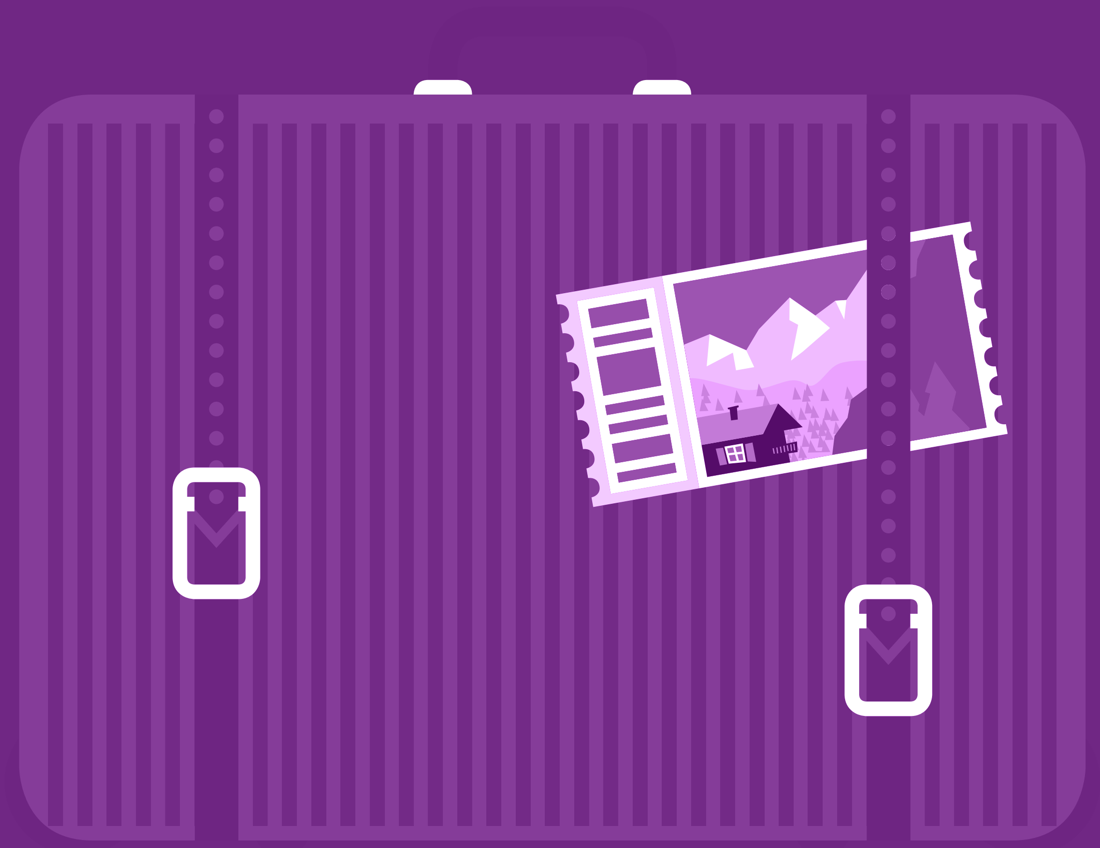
Without causing a loss of tax revenue, tonnage tax can contribute to the attractiveness of Switzerland as a business location.

To sacrifice tonnage tax for political reasons would therefore be a missed opportunity and inadvisable from a public finances perspective. It is thus still to be hoped that tonnage tax will be introduced in connection with CTR III.

Corporate taxation

Corporate income tax

Switzerland remains near the top of international tax rankings. When compared with European countries, the cantons of central and eastern Switzerland are extremely attractive economic regions from a tax point of view. The planned Corporate Tax Reform shows how Switzerland is reacting to international competitive pressures.

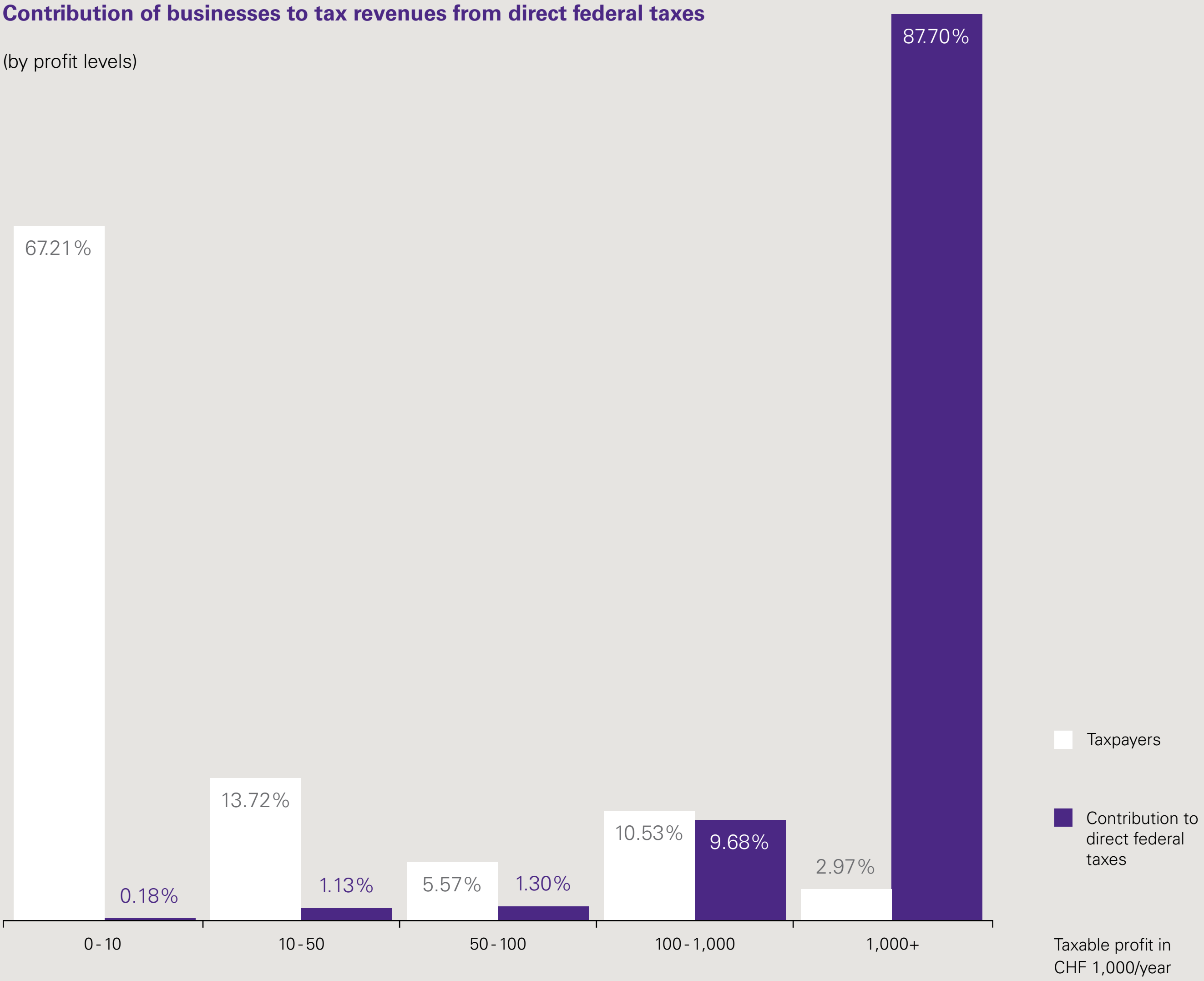


Which businesses are shouldering the tax burden?

Corporations' contributions to direct federal tax, which are graduated according to the profit levels, are borne by a small minority. While over two thirds of taxpaying corporations pay almost no taxes, 2.97% bear almost 90% of the direct federal tax burden. Privileged companies account for a share of 47.74% (about 4 billion[1]).

Contribution of businesses to tax revenues from direct federal taxes

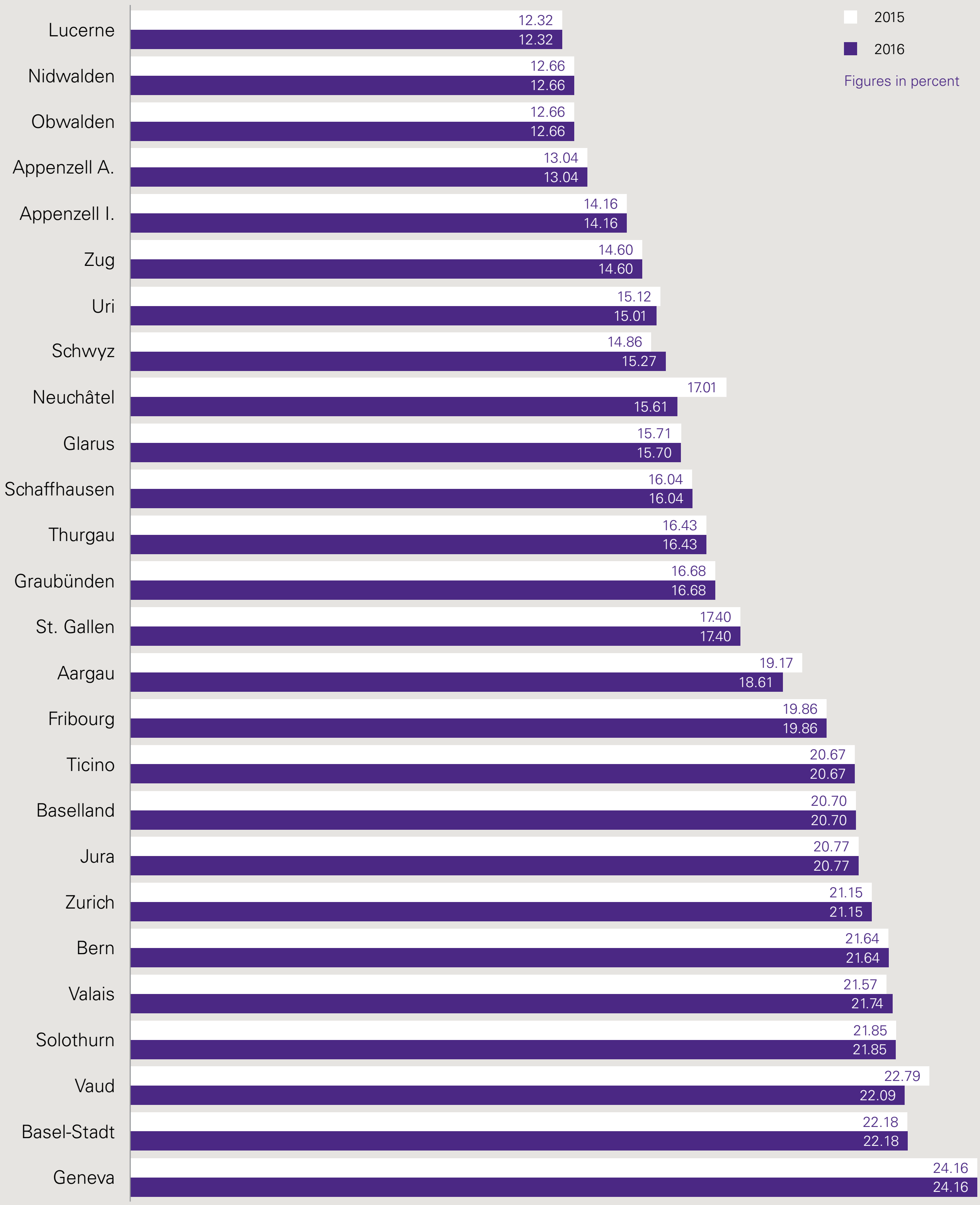
(by profit levels)



[1] according to the FTA
Note: latest available data for the tax period 2012. Source: Federal Tax Administration FTA, 2016: http://www.estv.admin.ch/estv/de/home/allgemein/dokumentation/zahlen-und-fakten/steuerstatistiken/direkte-bundessteuer.html#-979097136.

Corporate income tax rates in the cantons – 2015 and 2016

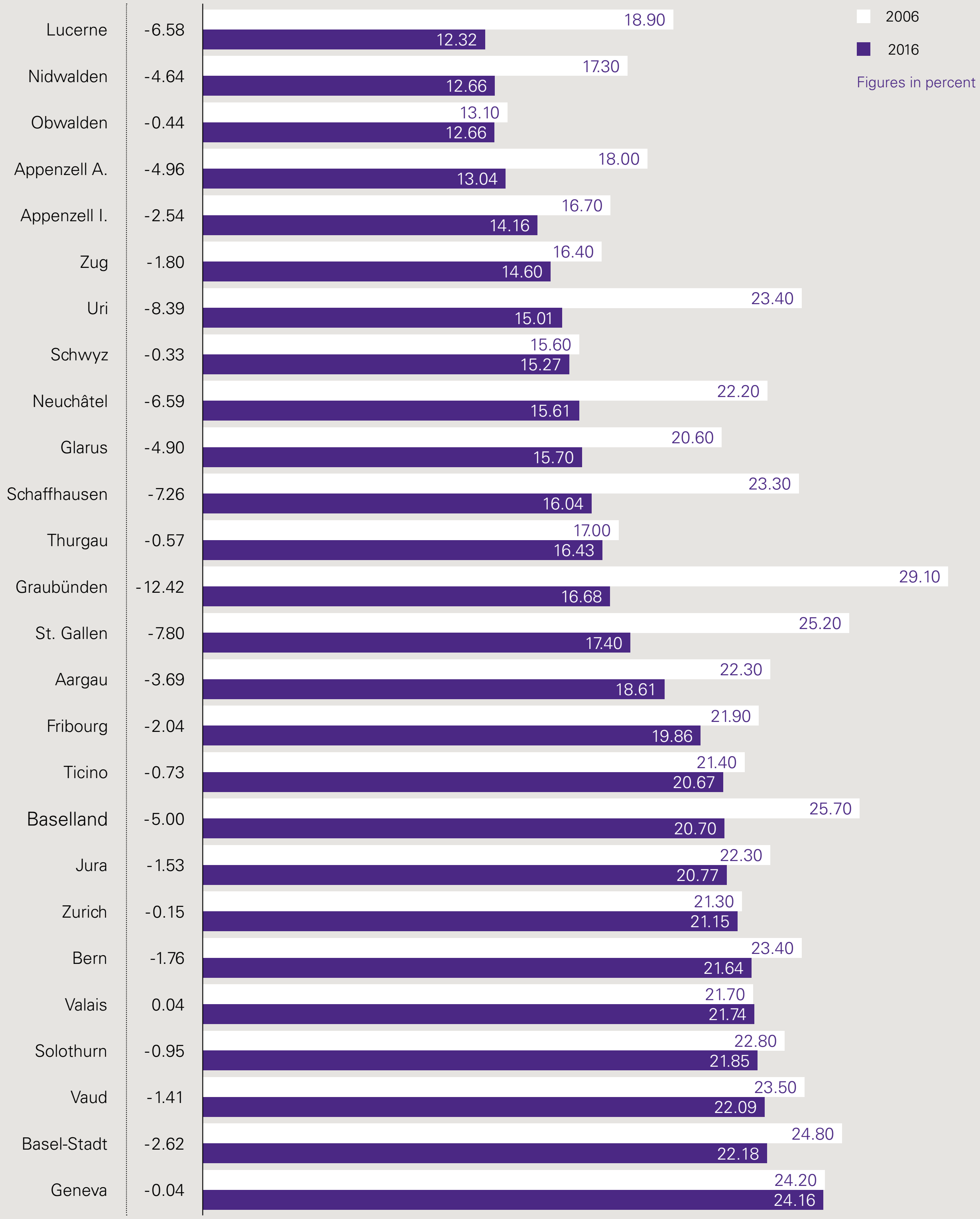
The cantons of central Switzerland still lead the tax ranking. Most cantons made no changes to ordinary tax rates. While Schwyz and Valais raised their tax rates slightly, Aargau, Uri and Vaud reduced corporate income tax. Only in Neuchâtel was there a significant reduction in the tax rate. Further reductions may well arise in the high-tax cantons in connection with CTR III.



Note: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Source: KPMG Switzerland

Corporate income tax rates in the cantons – trend in 2006 and 2016

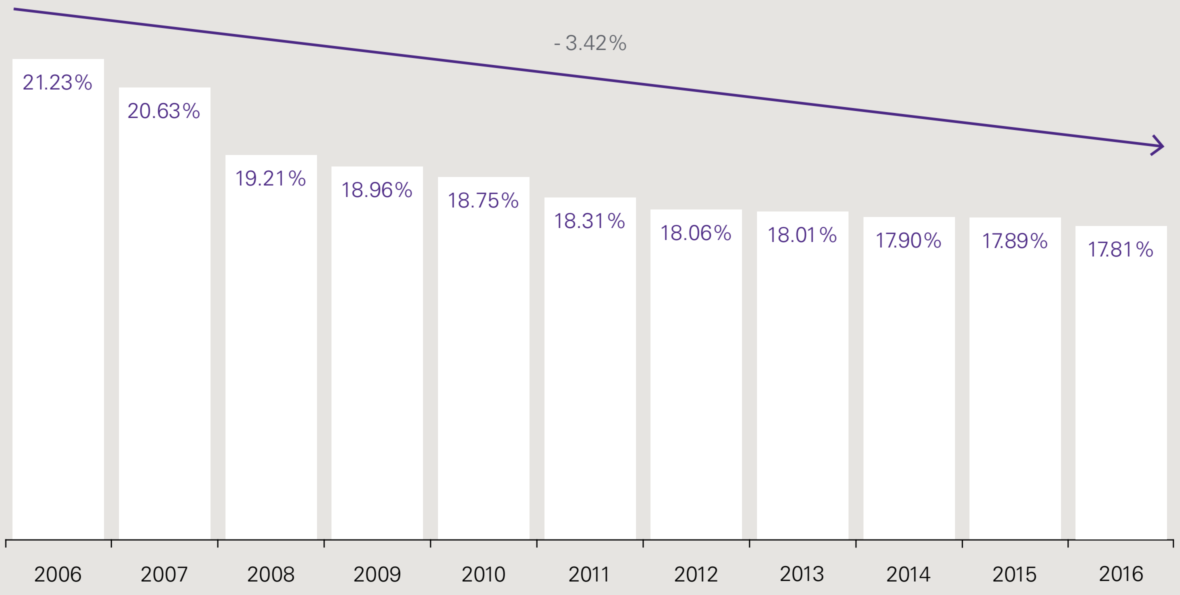
Besides the cantons of central Switzerland, cantons Appenzell A., Glarus, Schaffhausen, Neuchâtel, and in particular Graubünden, have also significantly reduced their tax rates for corporations over the past ten years. In the Mittelland region, western Switzerland and the city cantons, changes to ordinary corporate income tax rates have been smaller in these ten years. Only the canton of Valais has increased its tax rates slightly over the last decade.



Note: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Source: KPMG Switzerland

Corporate income tax rates in the cantons – trend from 2006 to 2016

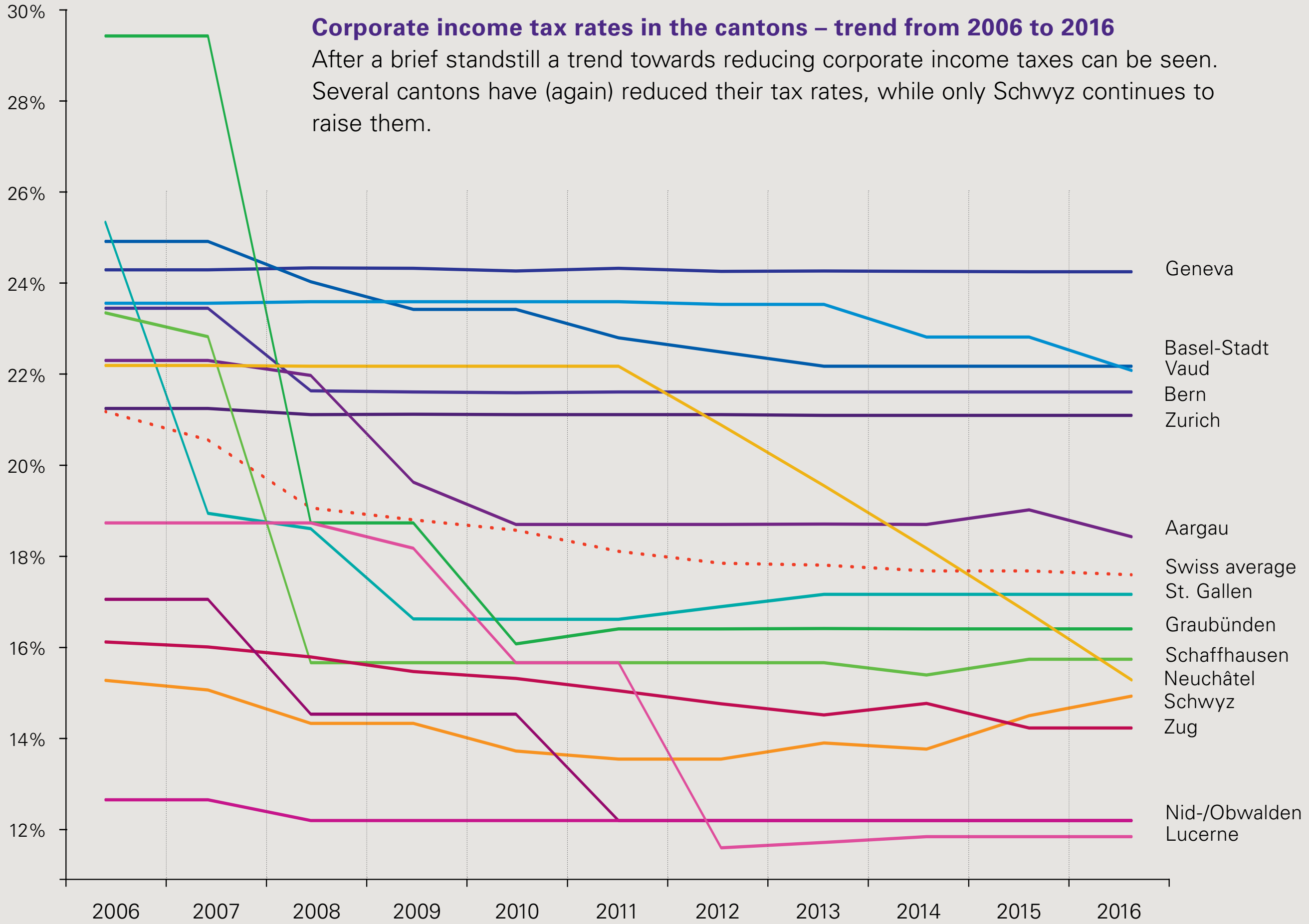
The corporate income tax rates continue to drop slightly on average. A further reduction is expected in the coming few years due to CTR III.



Note: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Source: KPMG Switzerland

Corporate income tax rates in the cantons – trend from 2006 to 2016

After a brief standstill a trend towards reducing corporate income taxes can be seen. Several cantons have (again) reduced their tax rates, while only Schwyz continues to raise them.

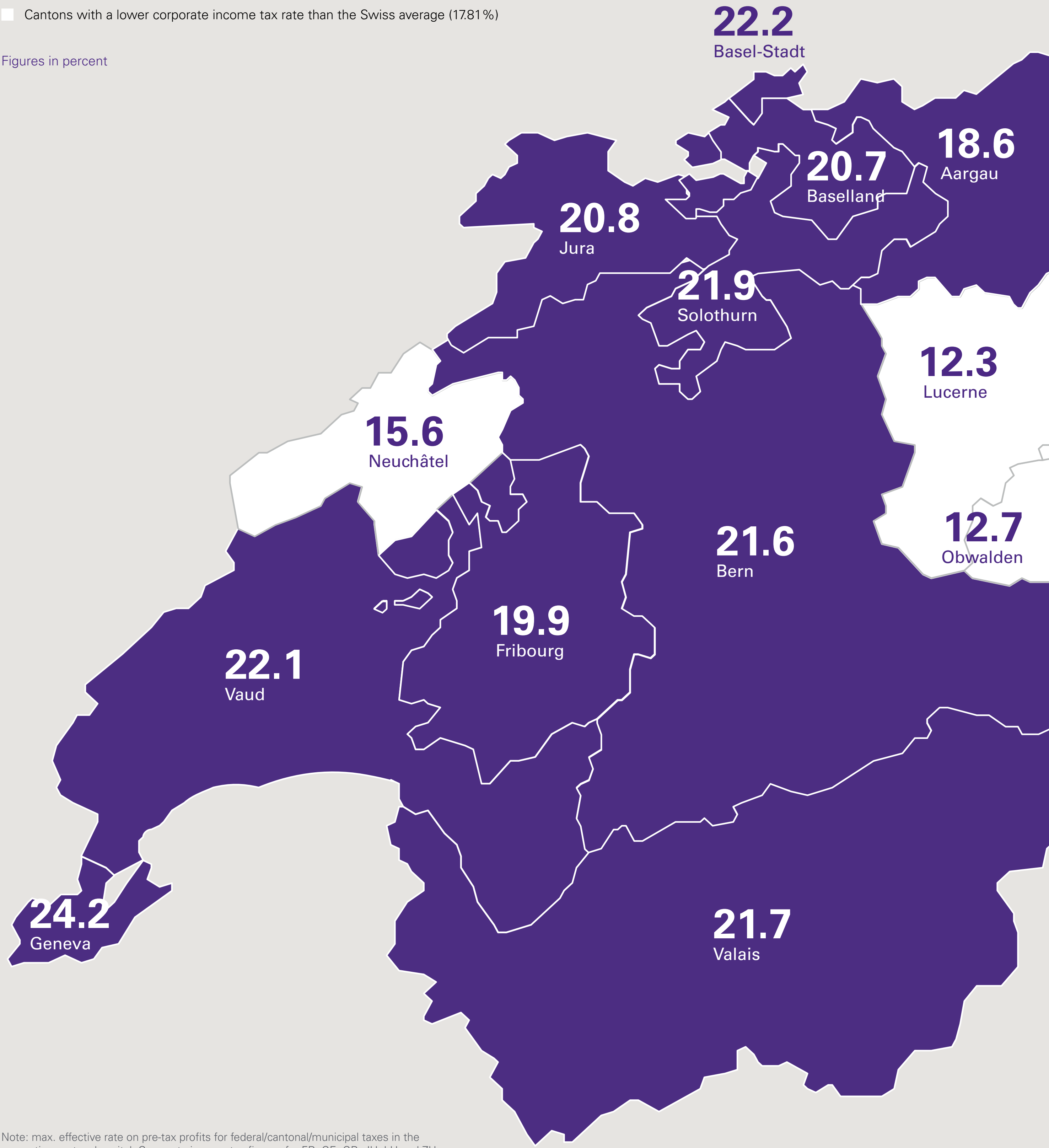


Note: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Source: KPMG Switzerland

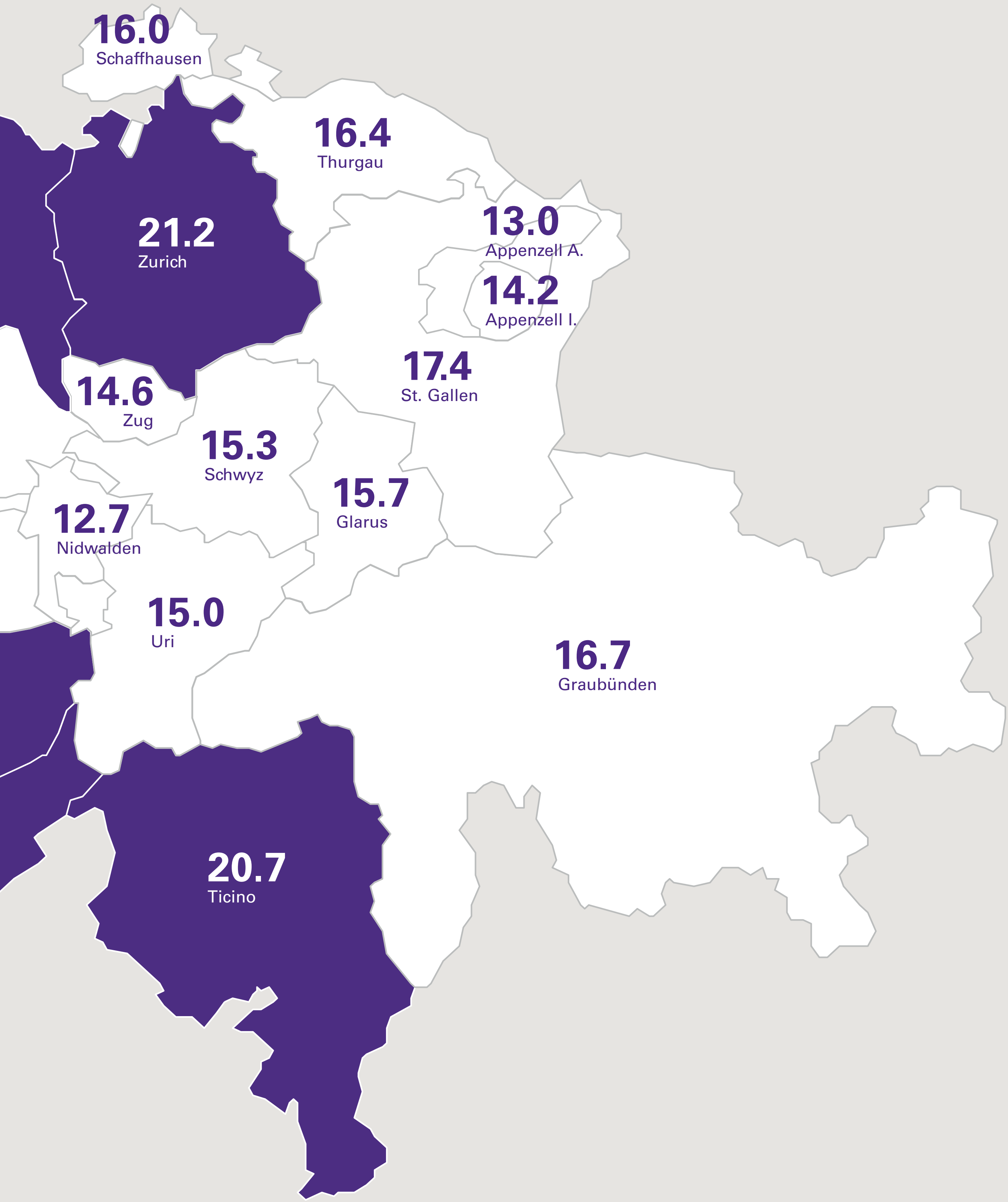
Corporate income tax rates in the cantons in 2016

- Cantons with a higher corporate income tax rate than the Swiss average (17.81 %)
- Cantons with a lower corporate income tax rate than the Swiss average (17.81 %)

Figures in percent

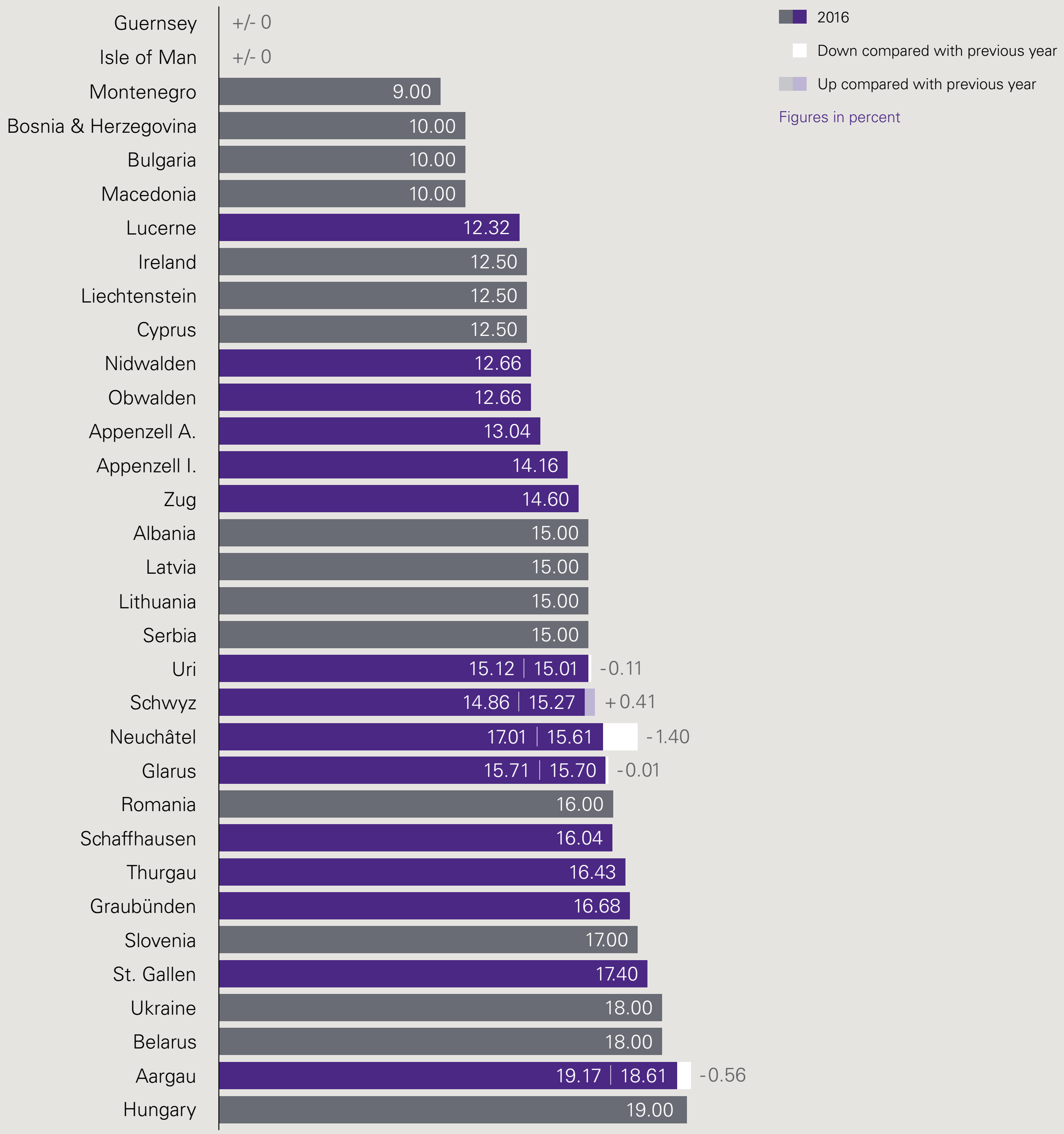


Note: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Source: KPMG Switzerland


16.0
Schaffhausen
16.4
Thurgau
21.2
Zurich
13.0
Appenzell A.
14.2
Appenzell I.
17.4
St. Gallen
14.6
Zug
15.3
Schwyz
15.7
Glarus
12.7
Nidwalden
15.0
Uri
16.7
Graubünden
20.7
Ticino

The cantons and European countries in comparison

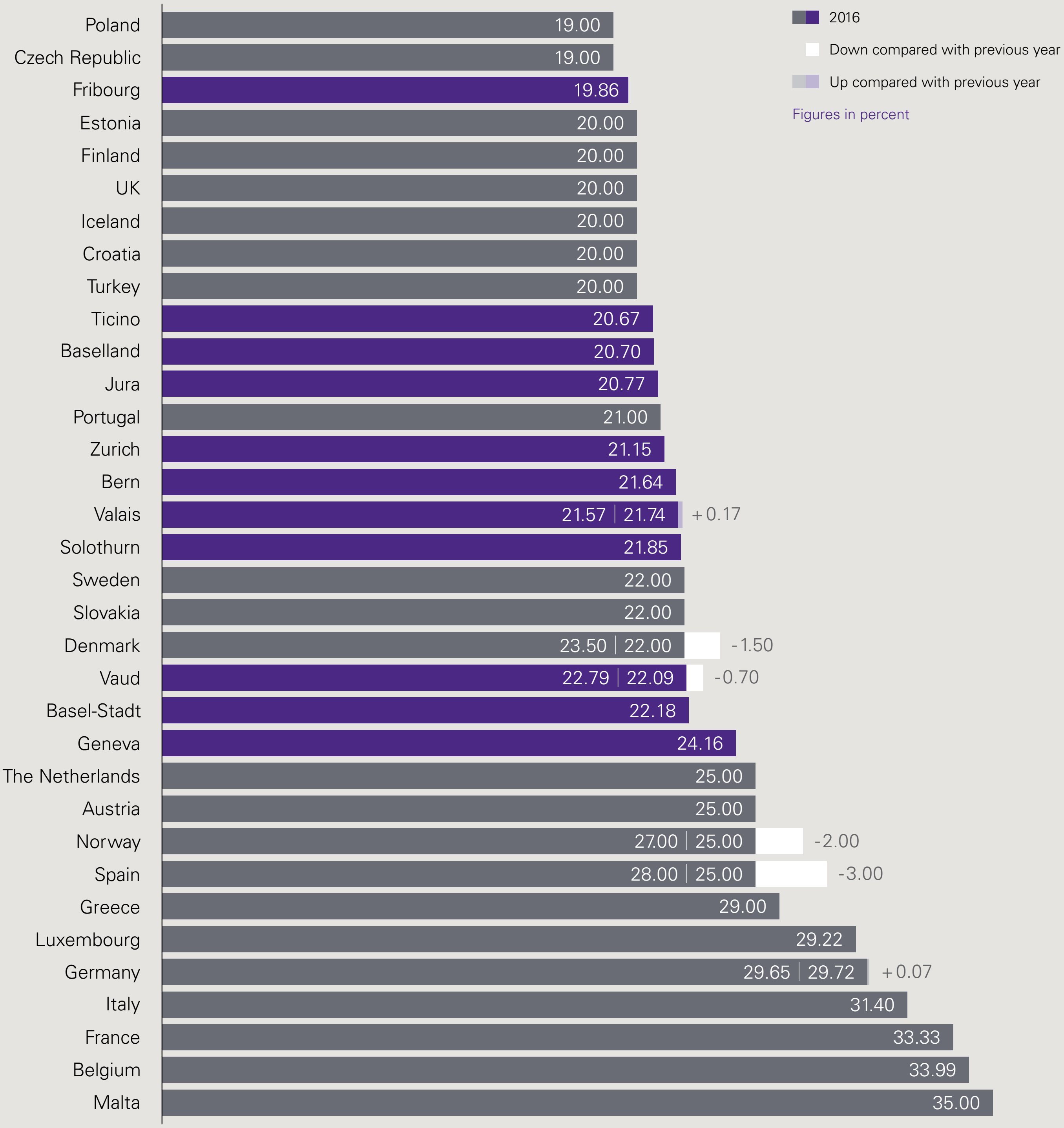
There has been little change in the European region. Minor changes by the cantons of central Switzerland in the previous year mean they remain in a strong position. Lower ordinary tax rates apply only in the Channel Islands as well as some (south-)eastern European countries. Ireland is still the main European competitor.



Maximum corporate income tax rates, CH: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Corporate income tax figures for FR, GE, GR, JU, LU and ZH for 2015. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-andresources/tax-rates-online/corporate-tax-rates-table.html

The cantons and European countries in comparison

Denmark, Norway and Spain have again reduced their tax rates significantly. Central European countries generally lag behind in terms of the attractiveness of their ordinary corporate income tax rates. In these countries in particular, a trend towards strategic innovation promotion (e.g. tax incentives for R&D&I) is apparent.



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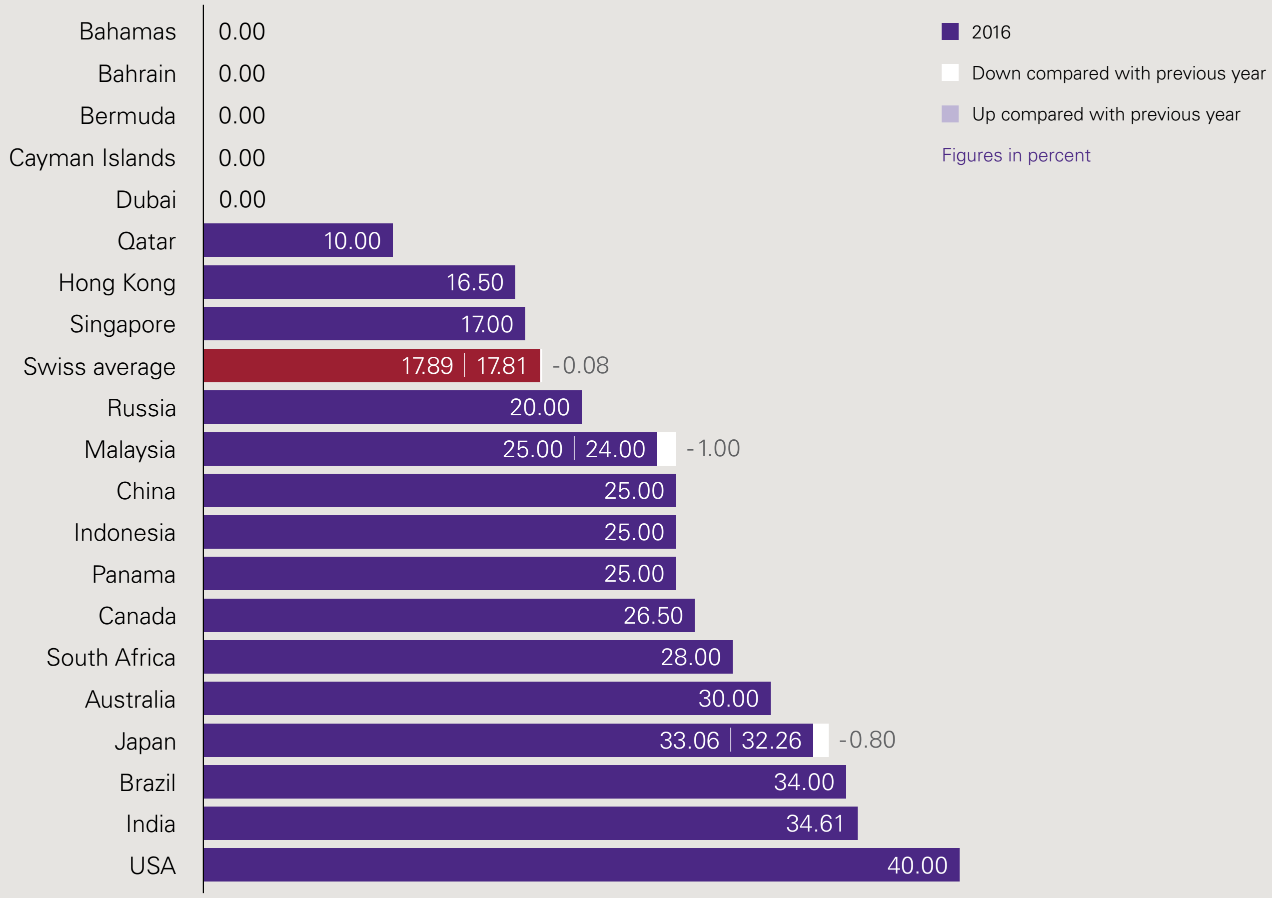
Global comparison – selected countries

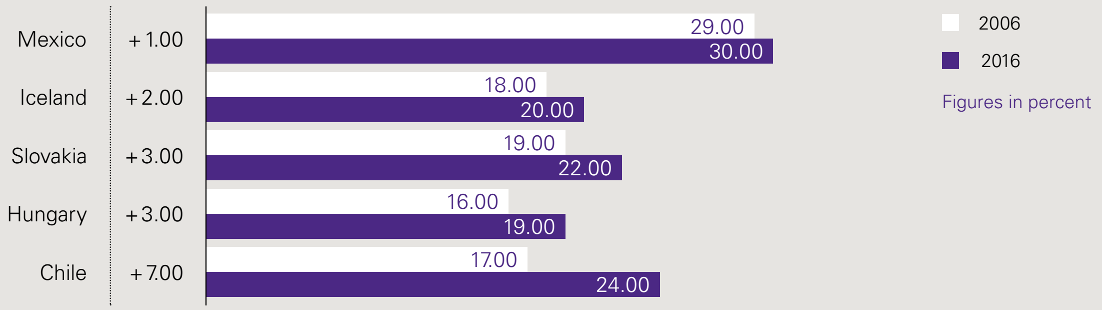
Besides the established offshore domiciles, Hong Kong and Singapore in particular are among the countries regarded as attractive tax locations. Switzerland occupies a lower middle position in the global competition ranks.



Maximum corporate income tax rates, CH: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

Trends: countries 2006 – 2016

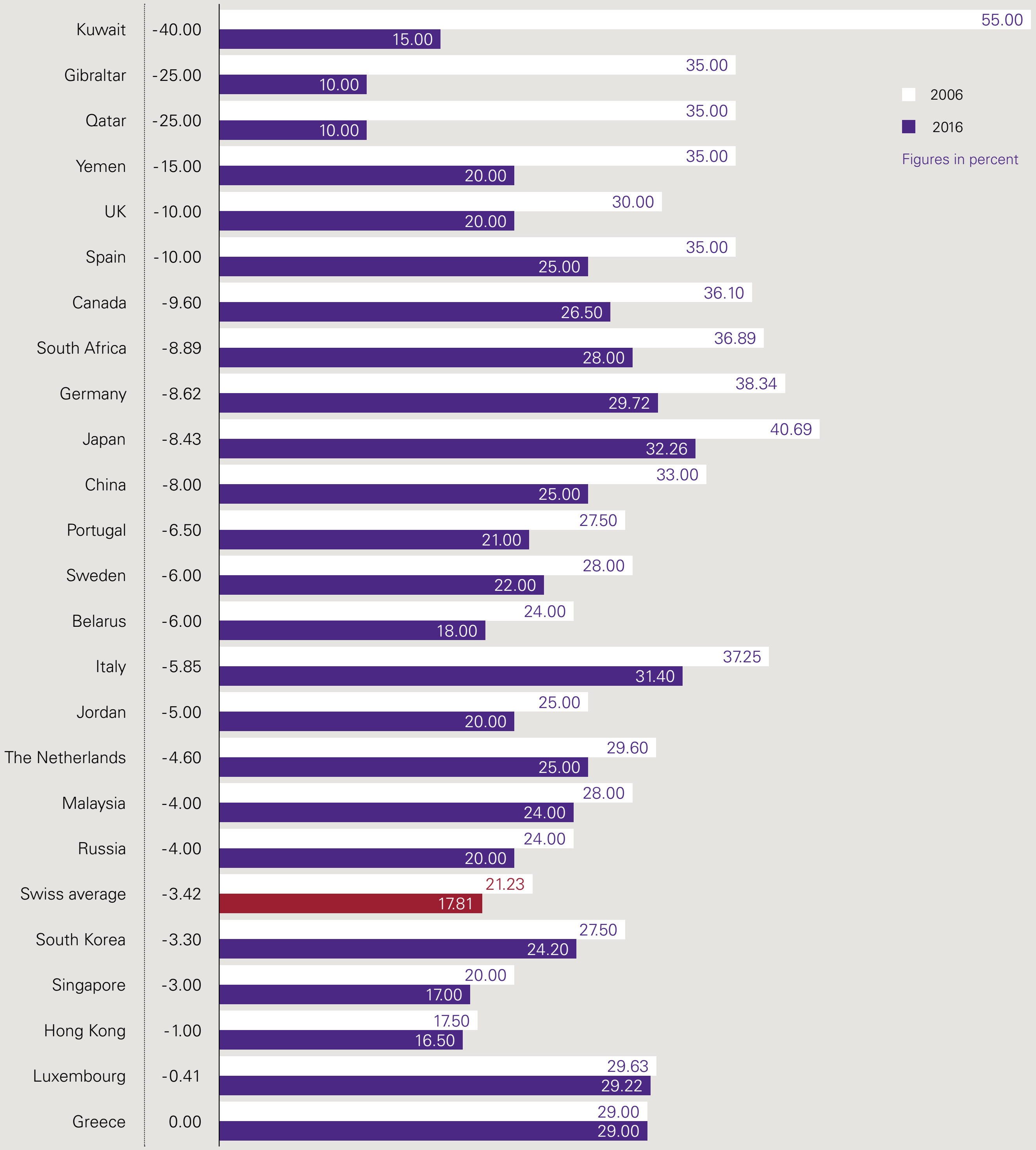
Only a handful of countries have raised their corporate income taxes since 2006 (some of those being countries with flat rate tax).



Maximum corporate income tax rates. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

Trends: countries 2006 – 2016

In the last ten years, some major cuts have been made to corporate income tax rates, particularly in the Middle East. The UK has announced its intention to cut the corporate income tax rate to 17% by 2020.



Maximum corporate income tax rates, CH: max. effective rate on pre-tax profits for federal/cantonal/municipal taxes in the respective cantonal capital. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html

Individual taxation

Income tax

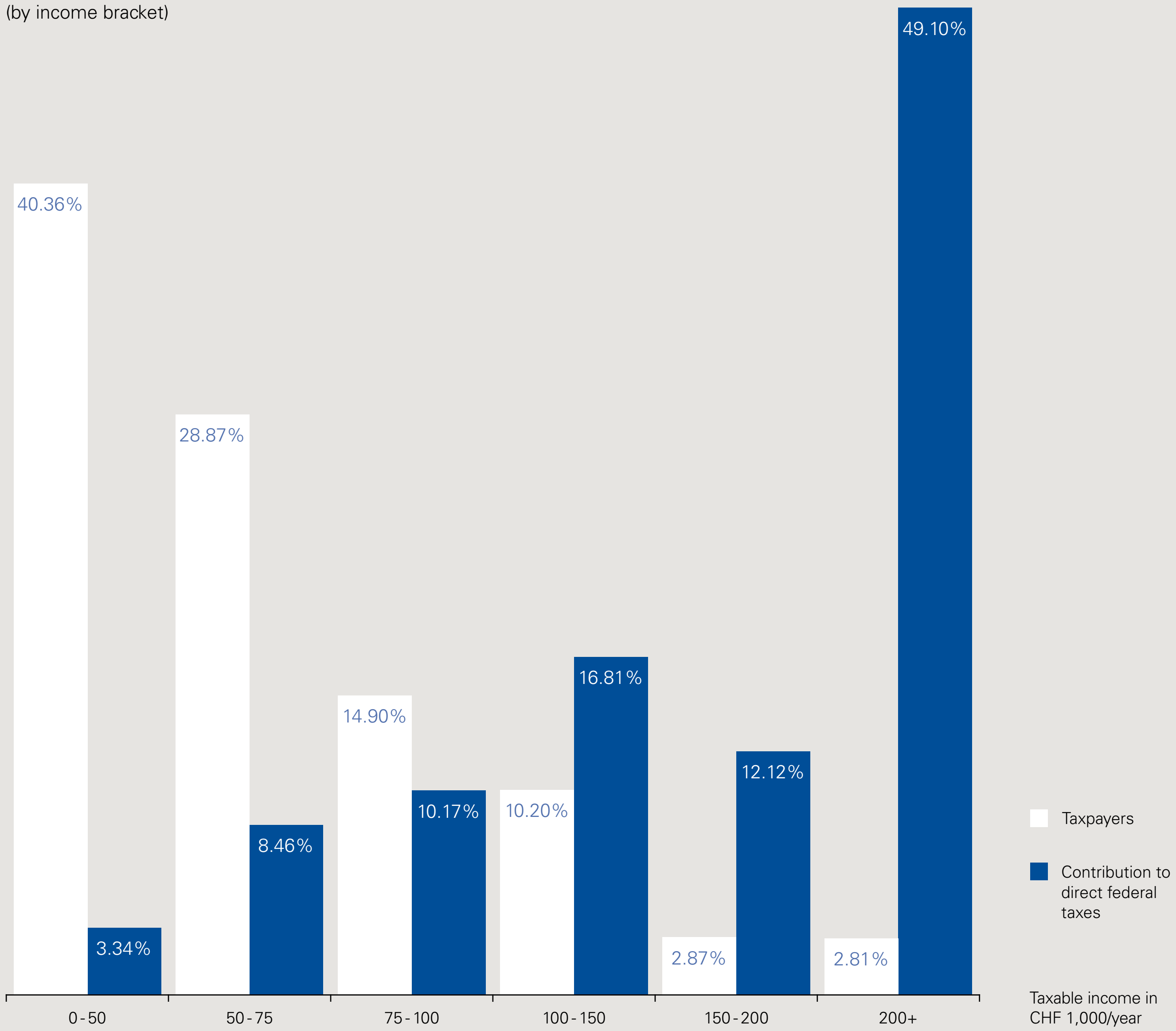
The cantons of central Switzerland are rated among the best for rates of tax charged to individuals on the highest incomes. The tax burden is borne by the wealthiest 1 % of the Swiss population.

Who shoulders the tax burden in Switzerland?

The 2.8% or so who are the top-earning taxpayers contribute a little under 50% of the direct federal taxes paid by individuals.

Contribution of individuals to tax revenues from direct federal taxes

(by income bracket)

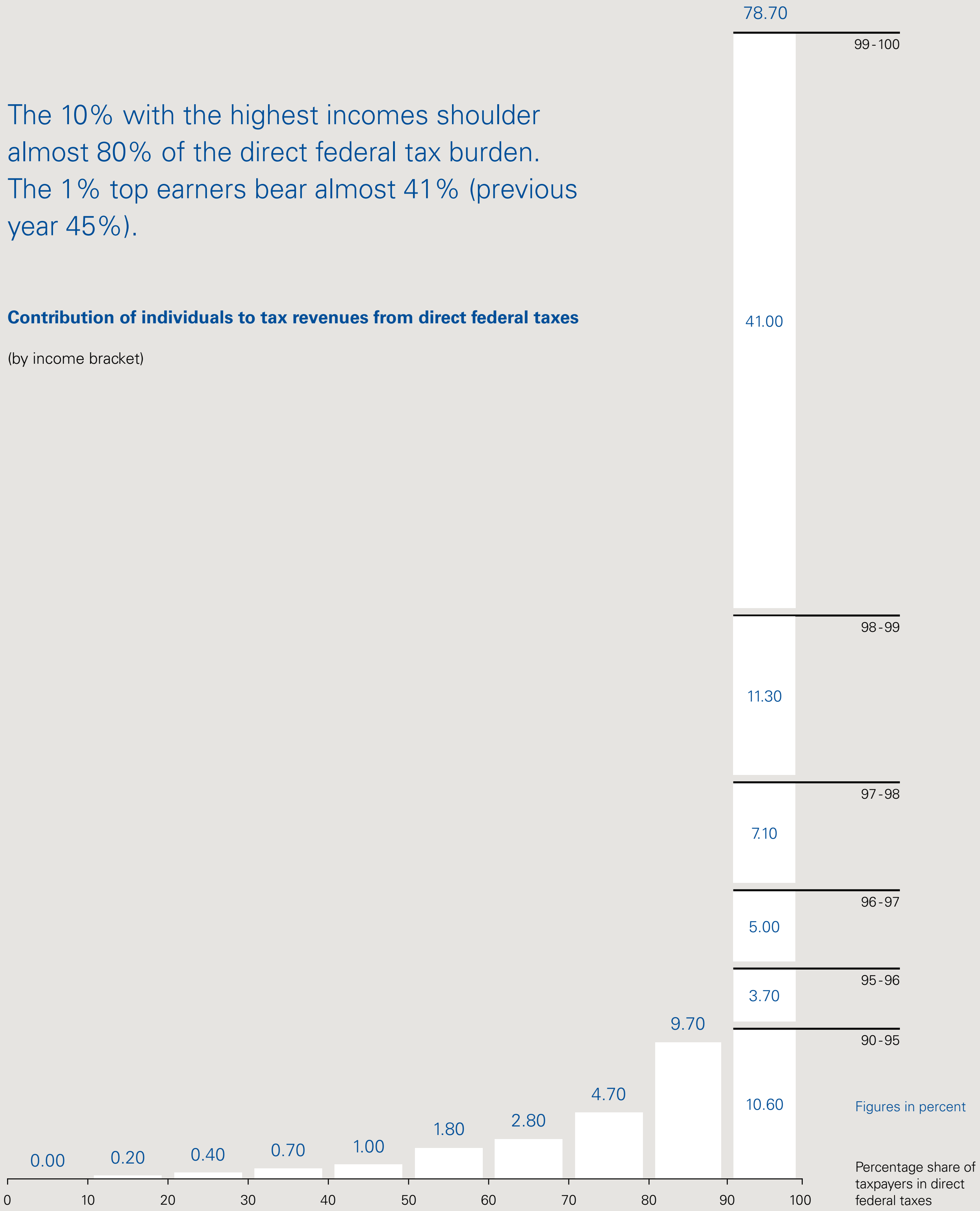


Note: latest available data for the tax period 2012. Source: Federal Tax Administration FTA, 2016: https://www.estv.admin.ch/estv/de/home/allgemein/dokumentation/zahlen-und-fakten/steuerstatistiken/direkte-bundessteuer.html#-979097136

The 10% with the highest incomes shoulder almost 80% of the direct federal tax burden. The 1% top earners bear almost 41% (previous year 45%).

Contribution of individuals to tax revenues from direct federal taxes

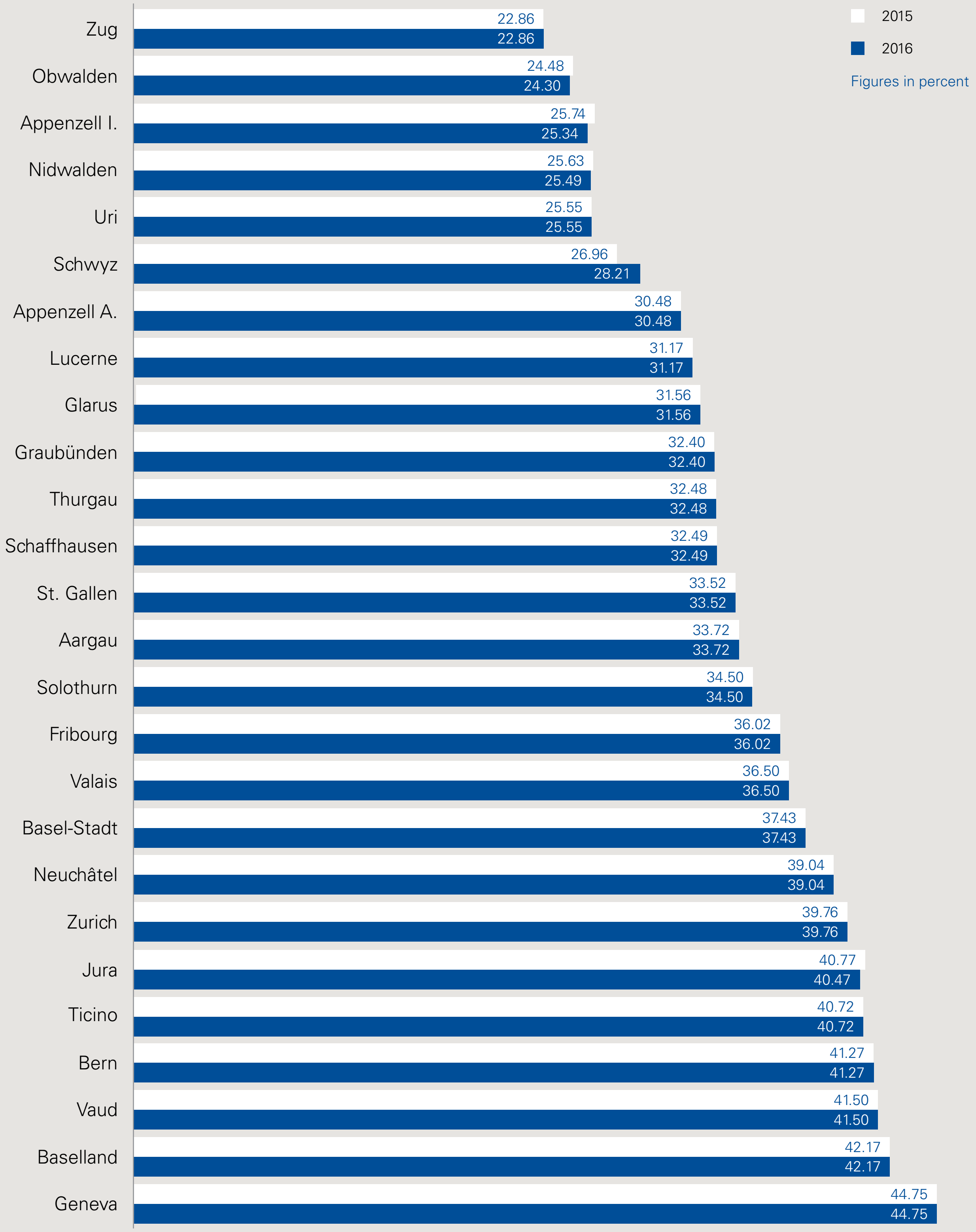
(by income bracket)



Note: latest available data for the tax period 2012, including persons taxed on a lump-sum basis and taxpayers where income taken into account in determining the tax rate is different from the taxable income. Source: Federal Tax Administration FTA, 2016: https://www.estv.admin.ch/dam/estv/de/dokumente/allgemein/Dokumentation/Zahlen_fakten/Steuerstatistiken/direkte_bundessteuer/perzentilen/Verteilung%20Einkommen%202012.xls.download.xls/00_Prozentuale%20Verteilung_VP12_nach%20Zivcd_d.xls

Income tax rates in the cantons – 2015 and 2016

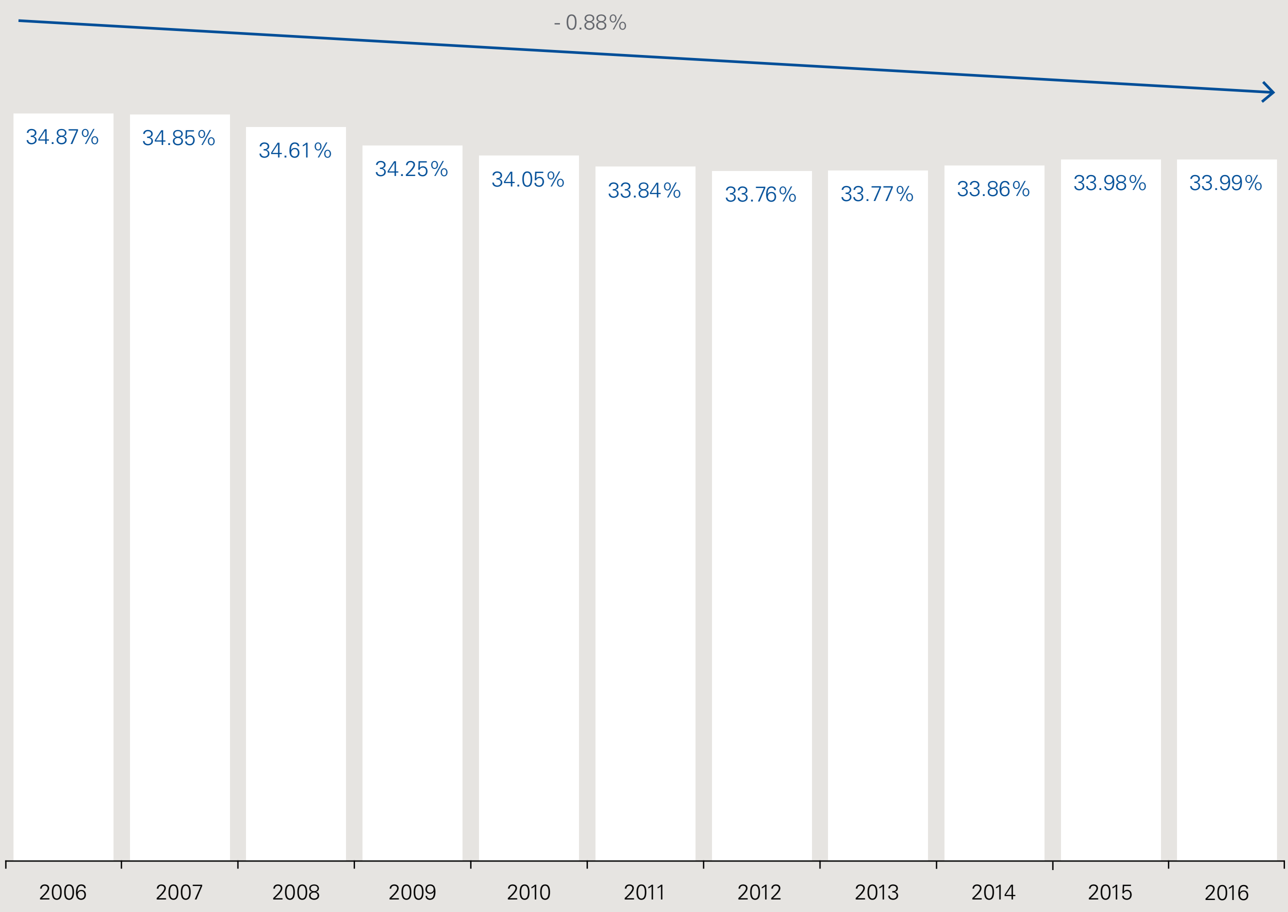
In an intercantonal comparison, the cantons of central Switzerland lead the tax ranking in the area of individual taxation. What is striking, however, is the substantial increase in Schwyz's tax rates. The top tax rates for individuals in western Switzerland and the Mittelland region are also comparatively high, as with corporate taxes.



Note: max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Income tax rates for AG, AI, LU, and TI are for 2015. Source: KPMG Switzerland

Income tax rates in the cantons – trend from 2006 to 2016

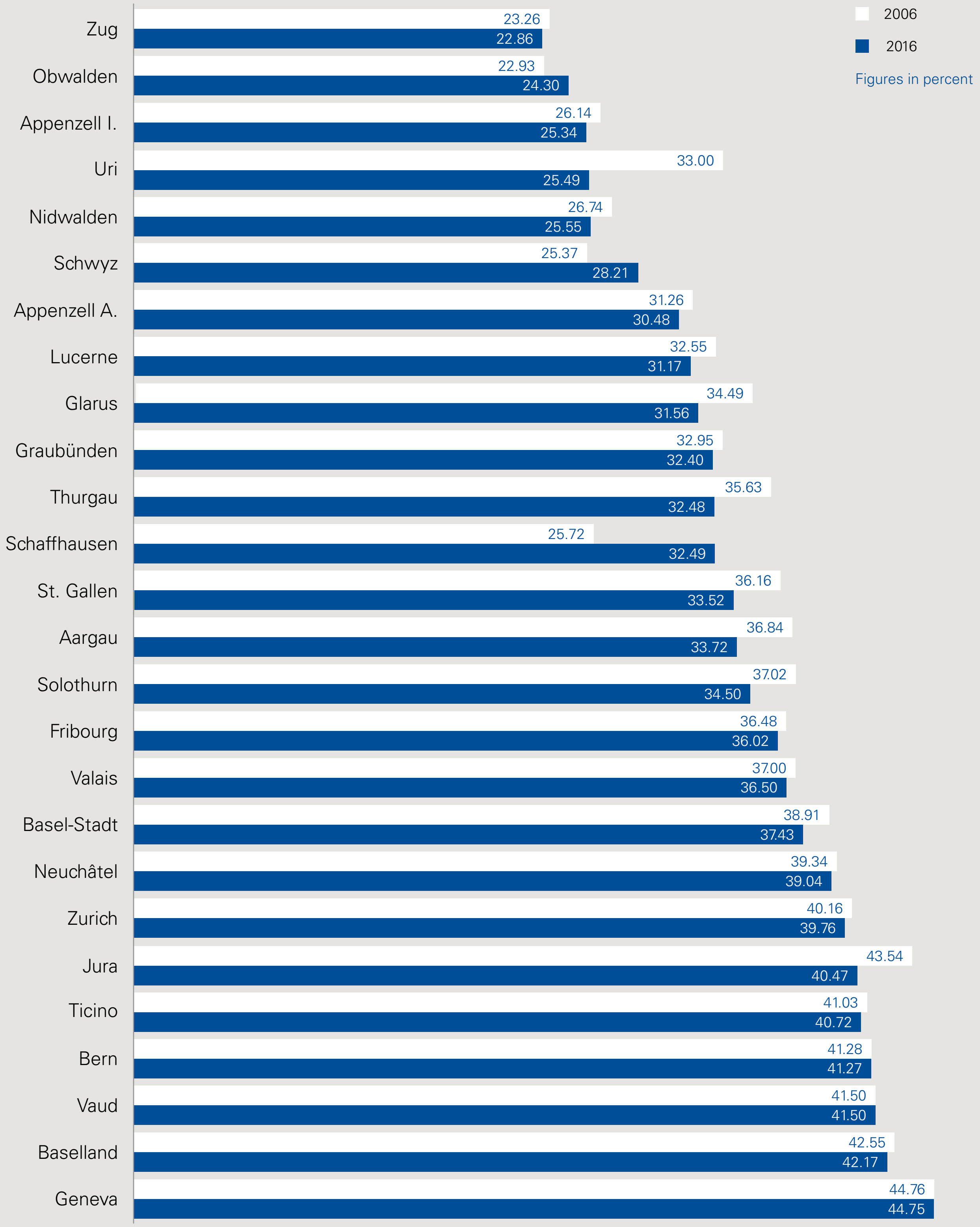
After a moderate downwards trend and a subsequent rise in the average top rates of tax, this now seems to have leveled off.



Note: max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Income tax rates for AG, AI, LU, and TI are for 2015. Source: KPMG Switzerland

Income tax rates in the cantons – trend from 2006 to 2016

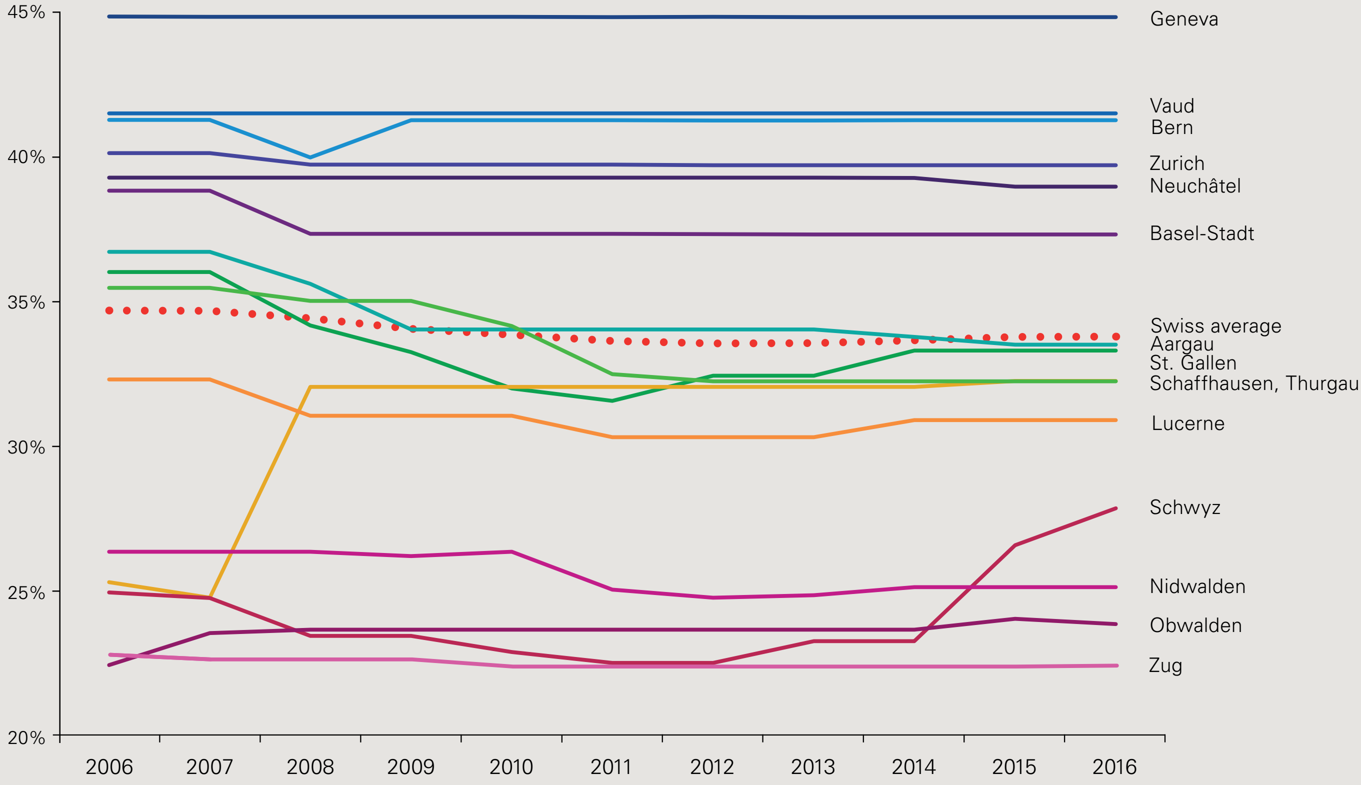
If tax rates over the past ten years are compared, it can be seen that the cantons of central Switzerland also lead the tax ranking here. The tax rates generally vary very little as between the cantons which traditionally have higher tax rates. Exceptions here are Aargau, Solothurn and Jura, which have made more significant cuts. Obwalden, Schwyz and Schaffhausen are the only cantons which have raised their tax rates.



Note: max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Income tax rates for AG, AI, LU, and TI are for 2015. Source: KPMG Switzerland

Income tax rates in the cantons – trend from 2006 to 2016

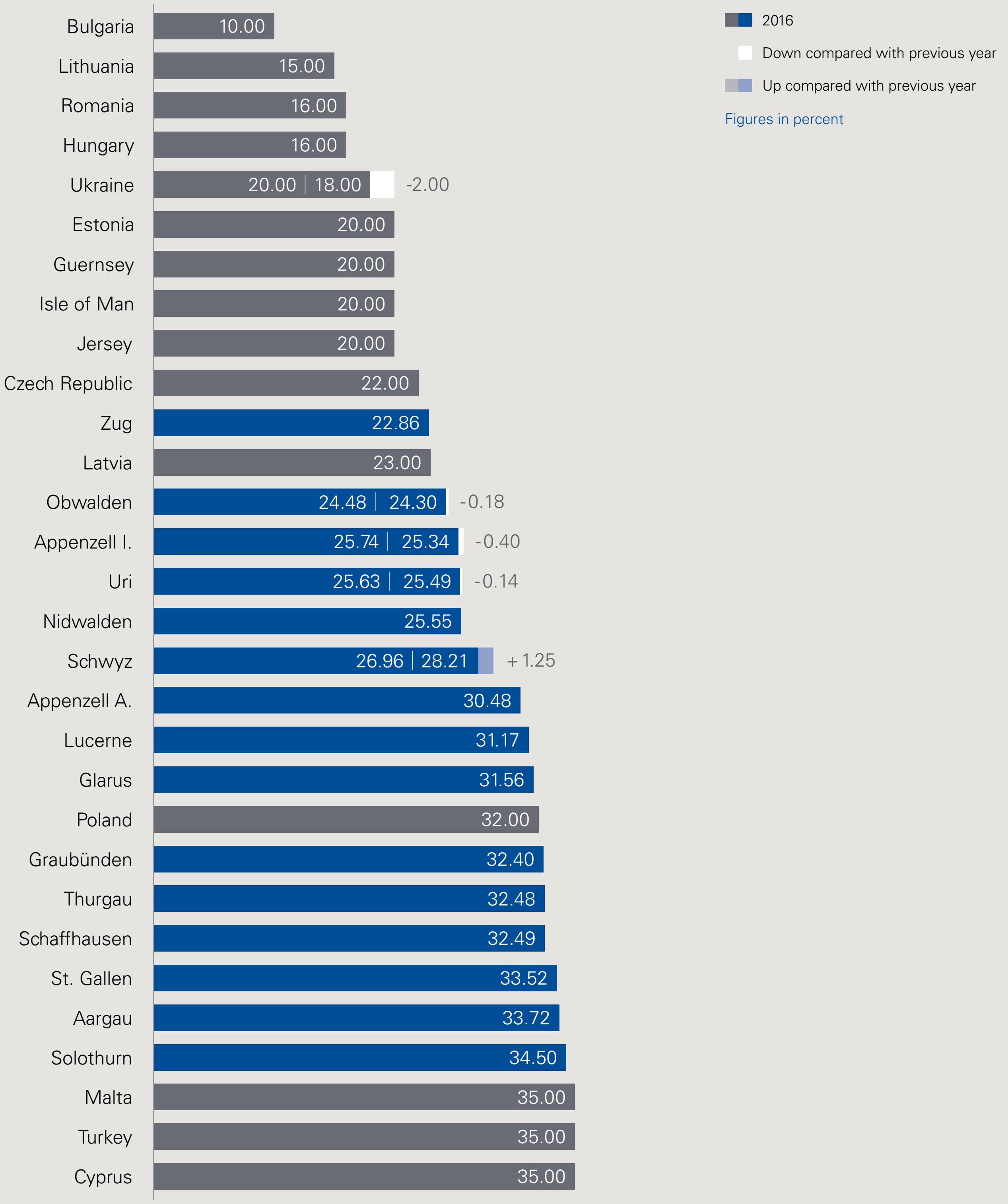
Apart from some major amendments in Aargau, Thurgau, St. Gallen (reduction), Schaffhausen and Schwyz (increase), top tax rates in the cantons shown remain largely unchanged.



Note: max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Income tax rates for AG, AI, LU, and TI are for 2015. Source: KPMG Switzerland

The cantons and European countries in comparison

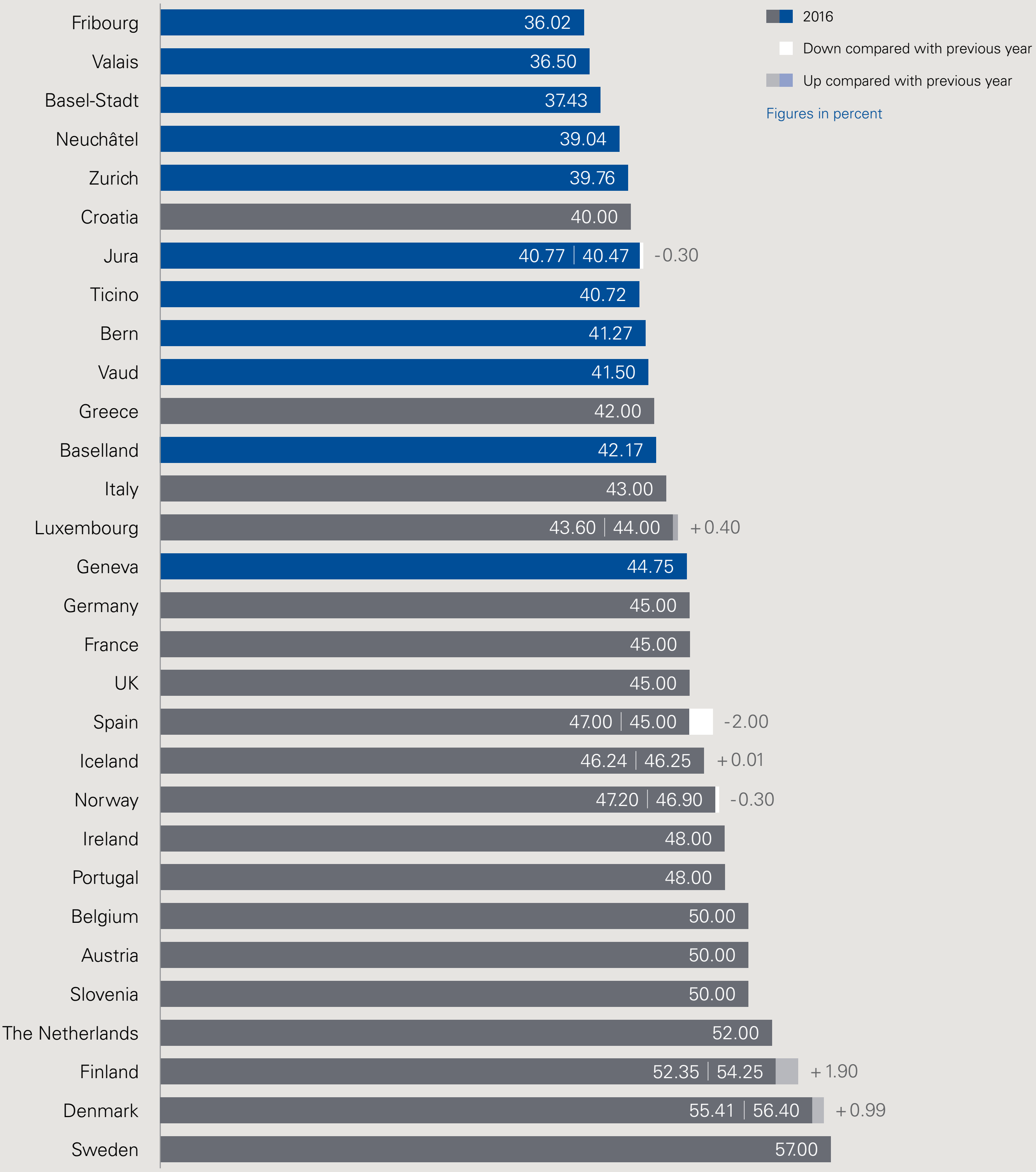
(South-)east European states still levy a particularly low rate of tax on the highest incomes (in some cases because of flat rate tax systems). Ukraine even reduced its tax rate further in 2016. The Swiss cantons sit approximately in the middle of European stats with regard to top tax rates on income.



Max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Aargau, Appenzell I., Austria, Bulgaria, Croatia, France, UK, Hungary, Italy, Jersey, Latvia, Lucerne, Malta, Poland, Sweden, Ticino, Turkey: income tax rates for 2015. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html

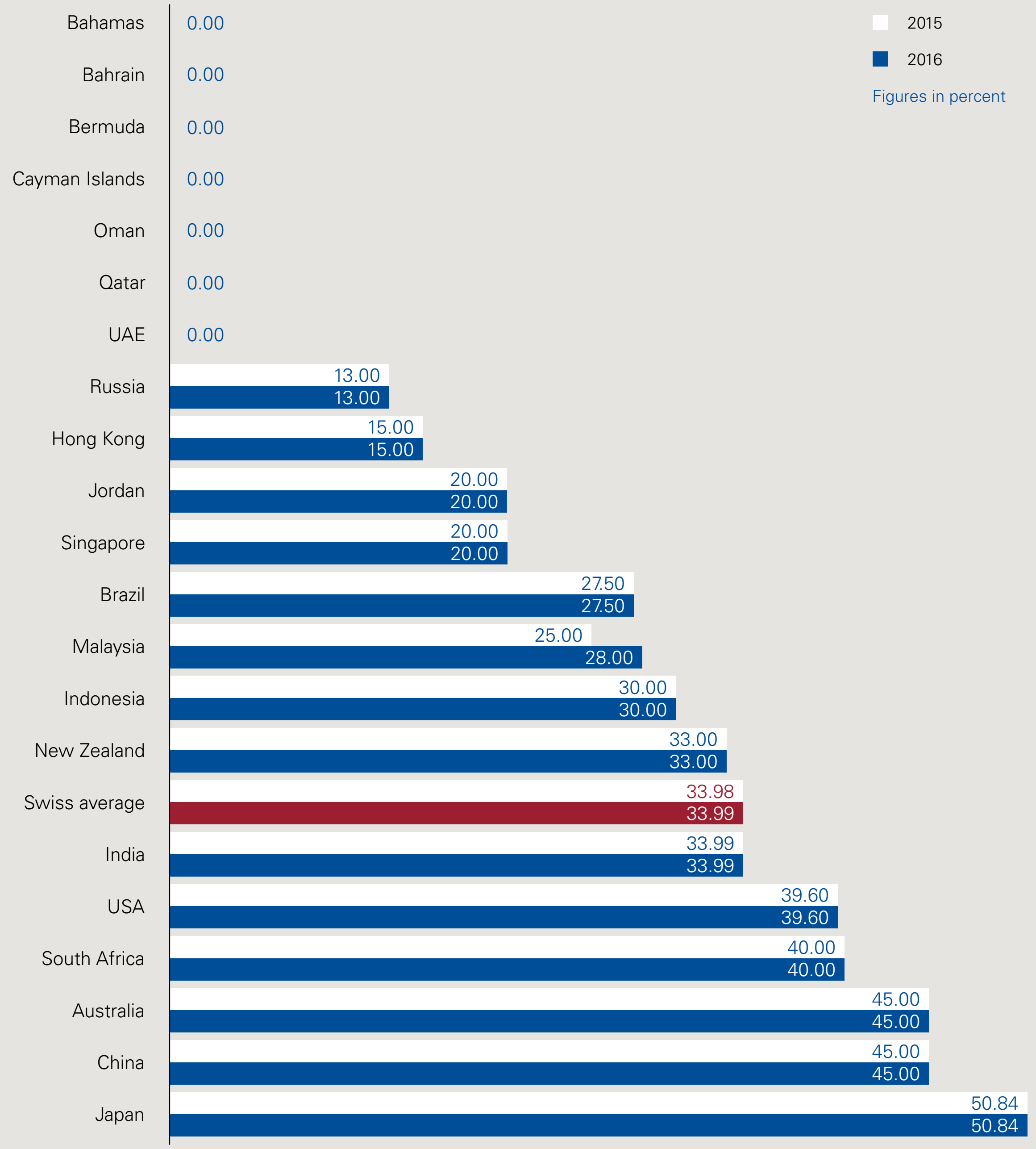
The cantons and European countries in comparison

Western European and Scandinavian countries levy income tax at relatively high rates. Although already ranking among the countries with the top rates, Denmark and Finland increased their tax rates in 2016.



Max. income tax rates for single taxpayers with no children and no religious denomination living in the respective cantonal capital. Aargau, Appenzell I., Austria, Bulgaria, Croatia, France, UK, Hungary, Italy, Jersey, Latvia, Lucerne, Malta, Poland, Sweden, Ticino, Turkey: income tax rates for 2015. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html

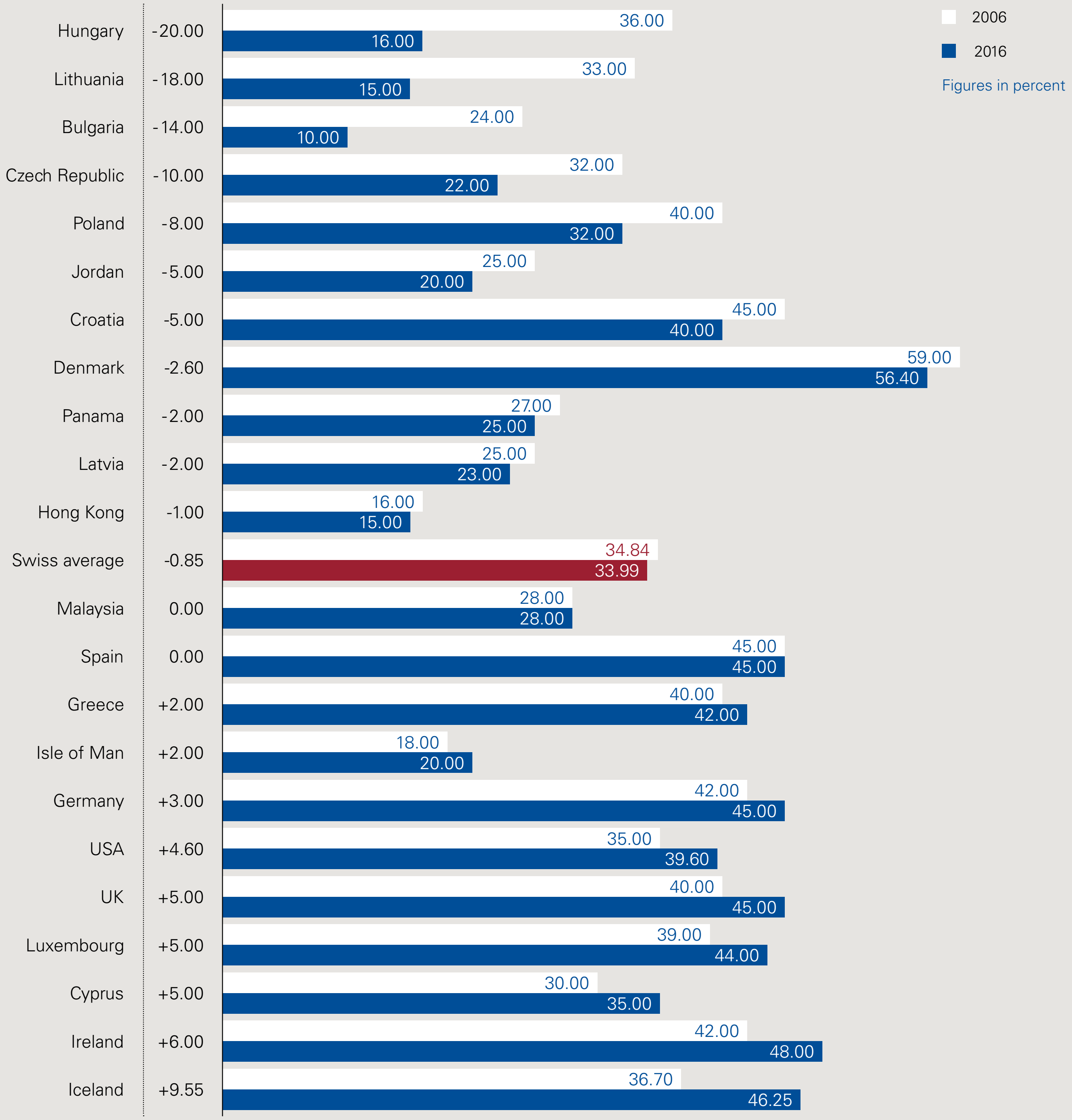
Global comparison (selected countries)
Established offshore domiciles and some countries in the Middle East levy no income taxes. There are also major differences in the taxation of income globally.



Max. income tax rates for single taxpayers with no children and no religious denomination living in the respective capital. Bahamas, Bahrain, Bermuda, Brazil, Cayman Islands, Hong Kong, India, Japan, Jordan, Oman, Qatar, Russia, Singapore, South Africa, UAE: income tax rates for 2015. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html

Trends: countries 2006 – 2016

Some states have introduced a flat rate of tax in the past ten years, which has significantly reduced top tax rates. An increase in the income taxes on the highest earners can be seen in Western Europe in particular.



Max. income tax rates for single taxpayers with no children and no religious denomination living in the respective capital. Bulgaria, Croatia, Hong Kong, Hungary, Jordan, Latvia, Poland, UK: income tax rates for 2015. Sources: KPMG Switzerland, KPMG International: https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html

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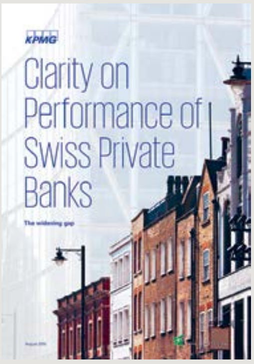

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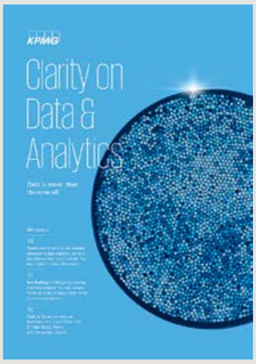

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