Swiss CTR III: Interaction and alignment with BEPS

Bruno Bächli from **Wenger & Vieli** looks at the proposed measures under Switzerland's corporate tax reform package, outlining the extent of BEPS alignment and assessing which measures are likely to be tweaked to become BEPS-compliant.

Google, Apple and Amazon under fire in OECD war on tax evasion

Apple faces "billions of euros" costs in tax avoidance probe, report says

Amazon faces European Union tax avoidance investigation

Headlines from newspapers and news portals

Today's international corporate taxation is based on the interaction between national tax laws and bilateral agreements. The primary purpose of the double tax treaties (DTTs), as part of these bilateral agreements, is the avoidance of double taxation. Lately it has increasingly been brought to the attention of the general public that these DTTs can be used to reduce taxation by means of a corresponding coordination with the national tax laws through international constructions – mainly by multinational enterprises (MNEs) – in which profits are separated from the place where there is substance and shifted to low-tax jurisdictions. Sometimes it is possible for a double non-taxation (in other words, non-taxation) to be achieved by such constructions.

The present developments were made possible by the global increase in tax transparency. This transparency introduced so-called harmful tax practices of the MNEs to the mainstream media. The world has become smaller as a result of progressive globalisation – and so has the tax world.

The 2008 financial crisis, which had an impact on the development of national budgets, speeded up the transparency process further. Compensation for missing funds needed for national budgets was primarily sought on the revenue side. Cuts on the expenditure side are politically unattractive and more difficult to enforce.

Apart from the EU, the Organisation for Economic Cooperation and Development (OECD) and the G20 are working on the base erosion and profit shifting (BEPS) project. The BEPS initiative has the objective of securing taxation of corporate profits in the place where value is created. At the same time, the international non-taxation of profits should be made impossible and the erosion of the tax base prohibited. The OECD's efforts are ultimately aimed at better alignment of place of taxation and location of economic substance.

In future, when management is choosing an appropriate location for mobile functions of an international group (for example financing, licence administration and so on), in addition to the usual evaluation process it will also need to take the elements of the BEPS initiative into consideration.

Just because of the above-mentioned transparency, considerations regarding a possible loss of reputation cannot be ignored when choosing a location. No manager wants to read headlines about his company in the press along the lines of those cited above.

Companies which perform the above-mentioned mobile functions have hitherto been typically located in so-called low-tax countries. Switzerland has also benefitted from this trend in the past. These companies frequently enjoyed a tax regime which led to privileged taxation of the company or its activities. This kind of company in particular is now confronted with innovations and questions in connection with Corporate Tax Reform III (CTR III) and BEPS.

Existing corporate tax law and BEPS

From a Swiss point of view there is no urgent need to amend the currently valid corporate tax law. The general tax conditions in Switzerland are attractive by comparison with other countries. Corporate profits are generally taxed at a low rate. Where a company was able to benefit additionally by using a tax regime, the result was often a very advantageous level of taxation.

The retention of these tax privileges would no doubt have led to unilateral sanctions by foreign countries (this has already happened in some cases) and the supposed advantages for the company would have been undermined (for example, by taxation in another country under controlled foreign company (CFC) or similar rules, or the refusal to grant treaty relief). In this respect, it was right and inevitable that Switzerland agreed to the existing tax regimes being abandoned. The report to the Swiss Federal Finance Department from the Steering Committee for Corporate Tax Reform III, published in December 2013, takes this up.

Although the tax privileges criticised by the EU are going to be abolished, at this point let us consider whether, and to what extent, the existing corporate tax law is in harmony with BEPS.

In principle, BEPS is not aiming at the level of the tax rates, that is, the trend to low tax rates in Switzerland is not in itself a problem under BEPS, so that there would be no immediate need to take action here under BEPS.

An element of the BEPS project is to neutralise the effects of hybrid mismatch constructions. These constructions were used to reduce the tax burden by exploiting the lack of coordination between the local tax laws of the corresponding countries, so that a deduction could be made in Country A without this being caught as income in Country B. Such constructions are basically not possible in Switzerland, due to corresponding legal provisions. In this connection it can be stated that the existing corporate tax law already meets the requirements of the approach targeted under the BEPS project.

Switzerland should also score well under the head of measures to prevent tax treaty abuse, since the Federal Tax Administration imposes high standards on the applicants with regard to entitlement to claim relief under a DTT. Where treaty entitlement is denied, treaty benefits cannot be obtained.

With regard to measures for countering harmful tax practices, Switzerland is in a less favourable position. Six Swiss regimes are being reviewed in the light of this measure. These are primarily the same regimes which are criticised by the EU. The regimes under attack are hardly compatible with BEPS.

With regard to the BEPS project, there is clearly scope for amendment of the existing corporate tax law. However, notwithstanding some reports in the media on this matter, it is not the case that the existing corporate tax law would ‘fail the test” on all aspects of the BEPS project. On the contrary, many of the aspects which are under discussion should already be covered in Swiss legal provisions or are dealt with correspondingly under the existing practice of the Swiss tax authorities.

CTR III

Due to the abolition of the above-mentioned tax privileges, Switzerland may become less attractive from a tax point of view. As mentioned, retaining the existing corporate tax law is not a viable strategy in today’s global tax environment, particularly given the continuing direction of travel.

Because of the foreign pressure on Swiss corporate tax law, the Federal Council launched the consultation on CTR III in September 2014, which lasted until January 31 2015. The object of CTR III is to take international developments into account in the Swiss tax system, to develop them further and at the same time to retain Switzerland’s competitive position. The Federal Council suggests abolishing tax privileges which no longer stand in accordance with international standards. These include the cantonal privileges (holding, domicile and mixed companies), and at federal level principal structures and finance branches.

Despite potentially negative effects, CTR III may also offer Switzerland an opportunity to be one of the first countries to implement competitive, internationally accepted and BEPS-compliant corporate taxation and to create or re-create the desired legal certainty for companies.

Even if the OECD and the G20 mention a “level playing field”, Switzerland is in danger of being a loser under the current developments, since the large countries can influence both the form and the actual territorial implementation of the international fiscal framework. In other words, the small countries have to accept the requirements of the large countries. Small countries do not have the same political and economic possibilities to assert themselves as the large ones.

Selected aspects of CTR III

The following section deals with selected aspects of CTR III and reviews their consistency with the BEPS project. Significant elements of CTR III include:

- Introduction of a Licence Box(extended measures should be considered, since the (modified) nexus approach – whereby income from a particular source should be linked to expense from the same source, for example research expenses should be connected with licence income – is being pursued;
- Introduction of a notional interest deduction; and
- Disclosure of hidden reserves on change of status.

Licence Box

A Licence Box is to be introduced at cantonal level. Here, reduced taxation would apply to income from intellectual property (IP) rights. Many European countries have already had corresponding arrangements for a while. Switzerland should therefore introduce this part of CTR III, also because Switzerland is a country with a very high rate of innovation.

The exact form of the Licence Box is under discussion. If the requirements for the qualifying income are too broad, there is a risk that the arrangement will not be in use for very long, due to potential international pressure. If the requirements are too stringent, such licence or patent boxes will be used less. The UK and Germany were involved in a controversy regarding the qualifications for tax privileged income from intellectual property; a compromise was found at the end of 2014. The UK wanted to continue with its broad Patent Box requirements, while Germany sought to have higher entrance hurdles required for qualifying income under the BEPS project. Agreement was basically reached that a privileged taxation for income from IP is only allowed if this income is linked to economic activities of substance. This compromise agreement now forms the basis for the EU and OECD requirements, which were subsequently also approved by the G20.

The nexus approach now pursued would not be advantageous for Switzerland, because MNEs which are affected by it have outsourced a large part of their research and development (R&D) work to other countries. In particular, the pharmaceutical industry (which is very important in the Swiss economy) has moved a significant part of its R&D work abroad.

To reduce or make up for possible disadvantages of restricted licence box conditions, a disproportionately high deduction for R&D costs should be considered. Such deduction should not be a problem from an international point of view, since various countries have corresponding provisions already. Such a deduction would further be positive for the Swiss location, as it would stimulate companies to keep research and development jobs in Switzerland or to move them here.

Notional interest deduction

Here, the deduction for interest paid is increased by making a special deduction from the taxable profit for notional interest on part of equity (interest-adjusted corporate income tax). This measure would help to equalise the differences in the tax treatment of equity and debt.

The cantonal tax authorities are critical of this measure, as they fear a considerable reduction in revenue as a result. In terms of tax theory, this removal or partial neutralisation of the different treatment of debt and equity would be acceptable and welcome. Based on the details of the proposed notional interest deduction, this would not go as far as existing solutions in other countries (for example Belgium), so that from today's perspective this measure would appear to be a method which should be BEPS-compliant. The OECD stated that it does not regard a notional deduction on equity as a hybrid financing construction.

Step up in value

Under this measure, a company which was able to benefit from a tax regime in the past would be granted the possibility of disclosing the hidden reserves formed during the period of the privileged taxation (including any internally generated goodwill). This suggestion is consistent and correct from a tax theory point of view. It should also be in line with the grandfathering concept which is recognised by the OECD and the EU. Due to the grandfathering, which should, in principle, be permitted by the OECD and the EU, this measure ought to be in accordance with the BEPS project.

Remaining a location of choice

If the general set-up after introduction of CTR III and implementation of the BEPS measures has a negative

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impact on the tax position, a group which is resident abroad and hitherto has only located a few group functions in Switzerland, such as group financing or management functions, will have to consider either moving additional activities to Switzerland or transferring the existing Swiss functions abroad.

In connection with the current developments in taxation it can, however, be assumed that non-tax factors will be of increasing importance when choosing the location for a company. As Switzerland was hitherto the domicile of numerous mobile activities of international groups, this development represents a danger, unless Switzerland can continue to be internationally competitive, and there is a threat that enterprises could relocate.

As a location for business and tax purposes, Switzerland must be in a position to stand up to international competition in the long term. Apart from the low taxation, the positive aspects of Switzerland are legal certainty, the quality of the human resources, a good transport infrastructure, the availability of international schools and the generally high quality of life. Finally, Switzerland‘s central position in Europe can be emphasised as an attractive feature when deciding where to base operations.

The efforts of the OECD, which aim at taxation where value is created, will ultimately mean that managements must ask in what location value should be created in future, or must necessarily be created in view of the nature and function of the business. This means that the decision for or against a location will usually result in a corresponding transfer of functions. And yet Switzerland still appears to be a very competitive location for a company. If Switzerland can succeed in attracting (additional) activities which create value, the present upheaval in international and domestic taxation of Switzerland may in the long term be an opportunity.