TAXE Committee : Country specific fact sheet Switzerland

Roadmap for Green delegation

0) Main data

- Switzerland is the world's biggest management centre for offshore accounts
- The right of taxation is not exclusively allocated to the federal government → there are two layers of business taxation 1. Federal 2. Cantonal
- Corporate income tax rates ranging from 19 to 24% are considered "high" tax rates according to the Big 4
- Effective corporate income tax burden can be as low as 5%; lower rate possible through tax base erosion such as depreciation of intellectual property, hybrid financing, tax exempt foreign branch allocation (as in the case of intragroup financing, see the Luxembourg-Swiss finance branch) according to KPMG
- No controlled foreign corporation (CFC) rules. CFC rules are a tool to prevent erosion of the domestic tax base and to discourage residents from shifting income to jurisdictions that do not impose tax or that impose tax at low rates.
- No withholding tax on interest, royalties and branch remittance tax. EU Parent-subsidiary, interest and royalties directives are applicable thanks to the Switzerland-EU Savings agreement so that interest and royalties might not be subject to WHT → This has encouraged the Luxembourg-Swiss finance branch tax planning for instance.

1) The Swiss Corporate Tax Reform III : a genuine tax system overhauling or a headlong rush toward tax dumping ?

The Swiss Corporate Tax Reform III bill was released in September 2014. It is Switzerland's answer to growing concern and pressure over its banking secrecy laws and tax system. Indeed, after lengthy negotiations and discussions between the EU and Switzerland, the parties signed a Memorandum of Understanding on July 1, 2014, in which Switzerland agreed to abolish certain tax regimes.
The subsequent bill is not yet enacted.
Should it be implemented, this major tax reform may give room for other harmful practices and sophisticated tax dumping.
On the one hand, it would end preferential regimes that have been strongly condemned by the EU, but, on the other hand, it would set up new incentives for aggressive tax planning.

We discuss the following :
a) the phasing out of the so-called "preferential regimes" by 2020
b) how the suggested new tax incentives set up in view of convincing MNEs to keep their HQ in Switzerland and luring other might result in a renewed harmful tax competition.

a. The supposedly end of "preferential" regimes..

The Swiss Federal Council has confirmed its intention to abolish certain tax regimes within the framework of the Corporate Tax Reform III, particularly those that provide for different treatment of domestic and foreign revenue ("ring-fencing"). They are known as statutory regimes and are of different natures. The mechanism used to obtain these preferential regimes is tax rulings. There are four main statutory regimes, namely:

- <u>Holding company</u>

3 requirements to qualify for the Swiss holding regime:

i. Its main purpose must comprise the holding and managing of long term investments in affiliated companies.

ii. The company cannot enter into any commercial activity in Switzerland.

iii. 2/3 of the company's total assets need to consist of qualifying shareholdings or alternatively, 2/3 of the company's total gross income must derive from dividends of qualifying shareholdings.

Except for income from Swiss real estate, which is fully taxable.
Should the criteria be met, a holding company is <u>not subject to income tax</u> at cantonal level, but only at the federal level. The applicable tax rate is therefore <u>7.8%</u>.
Dividend income and capital gains of qualifying investments benefit from the participation deduction system and are <u>tax free</u>.
The goal is to include as much IP income as possible (e.g.: trademark licensing) in order to decrease the taxable base.

- <u>Mixed company</u>

The mixed company tax privilege is available to companies which perform commercial activities <u>predominantly abroad</u>. According to the practice of the tax cantonal authorities, this is usually the case provided that at least 70% of both the expense and income positions are <u>foreign-sourced</u>. A mixed company benefits from an effective cantonal tax rate of 8.5% to 12%. 11,6% as for Geneva canton.

- <u>Principal company</u>

Principal companies are group companies that do not just take on important functions but also crucial risks and the <u>legal ownership of products</u>. In such a structure, former manufacturing companies are converted to toll or contract manufacturers and fully-fledged distribution companies are converted to commissionaires or stripped buy-sell distributors.
As a result, the Swiss principal headquarter generates its own sales in the market.

A sophisticated and very attractive taxation applies to Swiss principal companies. Should the company meet the requirements for such taxation the overall effective income tax burden of the company can be as low as 5%, depending on the functions and domicile of the company.

- Finance company

The Finance company is a legal structure where the Swiss branch of a foreign head office is in charge of the group finance and treasury activities in a tax efficient manner. The special method of income allocation provides interesting tax benefits. Taxation is ridiculously low (1,5%)

Effective tax rates of companies with special tax status

Type of company	Approximate effective tax rate
Holding company	7.8%
Mixed company	8.5 – 10.5%
License box (canton of Nidwalden)	8.8%
Finance company/finance branch	1.5%
Principal company	5.0 – 8.0%
Captive insurance company	8.5 – 10.5% on minimum profits

Source : Clarity on investment in Switzerland, August 2014, KPMG
http://www.kpmg.com/CH/en/Library/Articles-Publications/Documents/Tax/pub-20130719-swiss-corporate-income-tax-system-en.pdf

b. ..replaced by new iffy regimes

As preferential regimes are to be phased out by 2020, Switzerland will replace these regimes by the following new measures :

- Reduction of Cantonal corporate income tax rate

This is the most straightforward compensation measure of the package.
The cantons may reduce their ordinary tax rates in order to enhance their attractiveness. In addition, the cantons shall be entitled to reduce the capital tax on net equity related to participations, IP or group-loans.

- Swiss Patent Box

The IP Box or Patent Box system also exists in other EU countries (The Netherlands, Luxembourg, the UK....).
- The Swiss variation may be more expansive in its definition of qualifying income/assets.
- The details are being drafted, and final provisions are, of course, subject to further developments at the OECD and/or EU level in order to stay internationally acceptable. Particularly, the EU is reviewing all Members States Patent Box Regimes.

- In spite of these caveats, the objective remains an effective tax rate (including both federal and cantonal taxes) of between 2.4 and 4.8 %, depending on the location within Switzerland.

- Notional interest deduction (NID)

Again, a well-known system in some EU member states (Belgium, Luxembourg..).
The proposed Swiss NID regime would be applicable at both the federal and the cantonal level on the so-called "surplus equity". This surplus equity is the part of equity that exceeds an average, sound equity financing of a company.
As a result, deemed interest would be deductible on the part of the equity deemed to be in excess of the necessary core equity.

These measures reduce companies' tax bases. There have been talks between officials from the European Commission and Swiss officials. They lasted between 2012 and June 2014.
Despite the EU's latest conciliatory declaration, several EU member states have expressed fears that Switzerland may introduce new 'harmful' tax regimes to compensate for the enforced changes.
It is likely that the new Swiss tax rules to be enacted under CTR III should ensure that relocation to Switzerland will remain a very favourable option.

As put by Mark Herkenrath of Alliance Sud :

"The planned replacement measures (license boxes and other corporate tax cuts) are highly questionable from a developmental standpoint. They would continue to represent a powerful incentive for multinational corporations to transfer their profits from developing countries to Switzerland via internal company transactions, thereby depriving the country concerned of urgently needed government revenues. This would clearly contradict the aims (and successes) of Switzerland's development policy."

2) The Luxembourg-Switzerland Finance branch: the tax dumping axis

The Luxembourg-Switzerland finance branch is a mechanism designed to provide finance and related types of activities to affiliates of the branch. The finance subsidiary (SOPARFI) is located in Luxembourg, this SOPARFI has a branch in Switzerland.
At the same time it:
- concentrates profit in a low tax environment
- benefits from treaty protection
- permits full interest deductibility at affiliate level.

Unlike a corporation, a branch reflects an activity carried on at a specific location and cannot be taxable there just because it is registered at the local corporate registry.

To be effective for Luxembourg (and often parent company "CFC") tax purposes, the finance branch cannot be a letter box but must have substance. But this condition is easy to fulfil :

provided there is a real business carried on from the canton it operates, with employees on the payroll, a finance branch offers endless options for international tax planning.

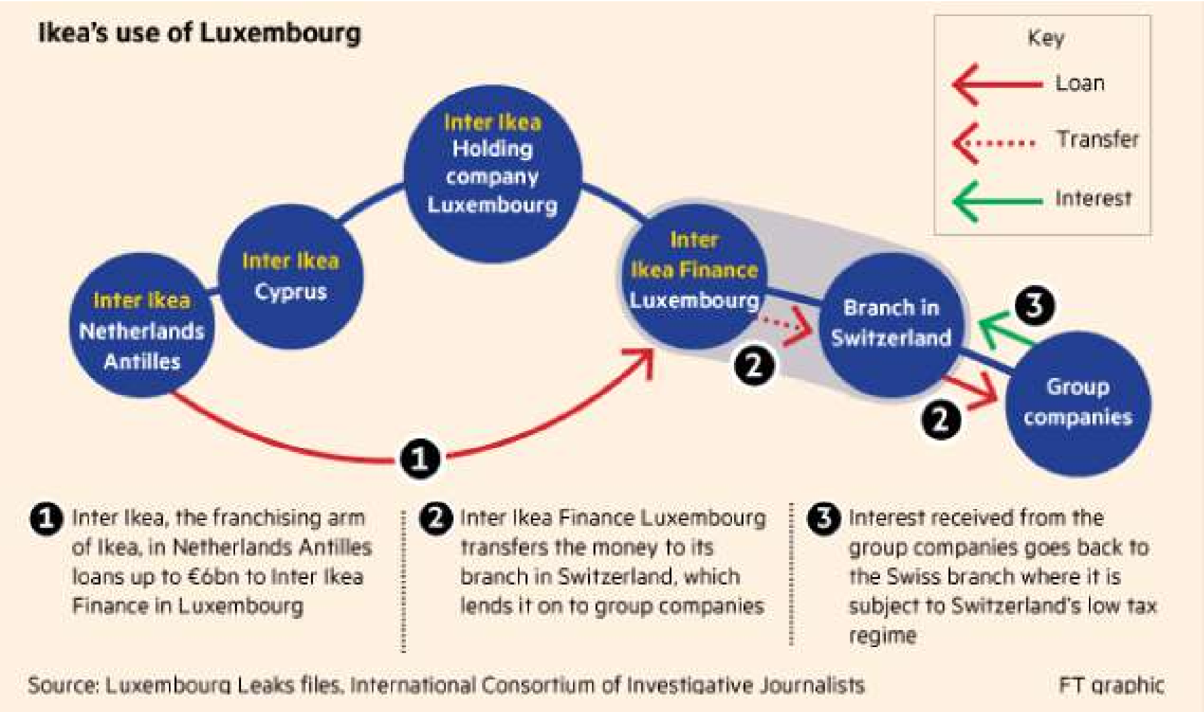
The IKEA case :

Lux Leaks revealed that the franchising arm of Ikea rearranged its financing, with the help of a Luxembourg-based structure and a low-tax Swiss branch based on a 2009 ruling.

This is how this aggressive tax planning worked →

- The Luxembourg entity (SOPARFI) lends money to its Swiss finance branch then
- The Swiss branch lends the money to Ikea Group companies around the world
- The interest received from the group companies goes back to the Swiss branch where it is subject to a very low tax regime.

By doing this, the loan interest is received and taxed in Switzerland at a very low rate. Passing the loans through Luxembourg incurs a tax charge on the sums involved at an effective rate of 0.03 per cent.



3) Economic substance requirement and Swiss anti-abuse rule

Economic substance is being emphasized in all attempts to overhaul the corporate tax regulatory framework.

The BEPS in its Action 2 “Neutralize the effect of hybrid mismatch arrangements”, Action 4 “Limit Base Erosion via Interest Deductions and Other Financial Payments” and Action 5 "Counter harmful tax practices more effectively, taking into account transparency and substance" directly targets the lack of economic substance.

Nowadays there are still many structures (in Switzerland) established in such a way that there is a so-called double non-taxation, meaning that in both countries there is no effective tax levied on the overall proceeds realised within the structure.

This is made only possible by the lack of enforcement by the Swiss tax administration of anti-abuse rules tackling the lack of economic substance regarding tax conventions.
Yet, Swiss legislation has anti-abuse rules thanks to Federal decree of 1962.
Principle: The anti-abuse decree contains measures to prevent non-residents from using Switzerland's tax treaty network to obtain treaty-protected income from third countries.
Nevertheless, this decree was relaxed in 2010 and conditions to benefit from the double-tax treaties were made more flexible for finance companies or active IP companies.

For instance, contrary to previous practice, the Federal tax administration will consider companies whose activities consist primarily of obtaining or granting loans within a group of companies using qualified staff (i.e. treasury companies undertaking cash-pooling activities, etc.) - which is typically the case of Finance companies - as creating a real added value, so that such companies can be considered active companies for purposes of the anti-abuse decree.

The active status is favourable as it allows companies to pay more than 50% of their treaty protected income to non-resident entities or individuals (e.g. Group companies in the IKEA example see above)

3) Swiss cantons: The Geneva case

Switzerland is a confederation that is divided into 26 cantons. Each canton determines its own tax legislation and sets its own tax rates. As a result, each Swiss income taxpayer is subject to at least two different tax laws: direct federal tax ('Direkte Bundessteuer', 'impôt fédéral direct', 'imposta federale') and cantonal tax ('Kantonssteuer' or 'Staatssteuer', 'impôt cantonal', 'imposta cantonale'). The communities also set their own tax rates and raise their community tax usually by adding a supplement to the cantonal tax.

Geneva has been worried of the recent developments as it was highly beneficial of the statutory regimes. Relying on these regimes, Geneva maintained a higher corporate income tax rate than most of the other cantons (24.2 % to be compared with the 11,5% of Zug)

Geneva canton highly relies on the statutory regimes. Therefore, it is looking for solutions to keep Multinational corporations' activities in its jurisdiction.
Mr. Hiler, a former Geneva local councillor in charge of finances, warned that the reform may imply "huge losses" and threats of relocation as Geneva is one of the cantons that could lose the most from the reform.
He therefore endorsed a decrease of the effective corporate tax rate from 24 to 13% in order to align business taxation with other cantons. By the way, this measure is the number 2 priority of the new council elected in 2014.
He also endorses the view of a large base for future IP box.

Geneva canton is also deeply hosting a free port that has been scrutinized by international media (The Economist, The NY Times, Mediapart) and for which some grey areas remain (see below Free port part).

→ It is possible to build on the Geneva case to question how will cantons react to the Corporate income tax reform and how can we ensure that the replacement measures such as the Patent boxes or the notional interest deduction will not end up in being used as substitute tools for aggressive tax planning.

4) Lessons from the US-Switzerland tax dispute

In 2010, The US used a strong arms tactics to fight tax avoidance by its taxpayers - individual taxpayers and Multinational corporations alike -. The FATCA (Foreign Account Tax Compliance Act) introduced a reporting regime for financial institutions with respect to US taxpayers' accounts abroad.
The obligation is two-fold:
- U.S. taxpayers must report certain foreign financial accounts and offshore assets
- Foreign financial institutions must cooperate and report financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.

This strong-arms tactics has worked with Switzerland. Indeed, the Helvetic confederation had no choice but to comply in order to prevent retaliatory measures that would have damaged its economy.
To that end, they signed an agreement in 2013 that was to be implemented from 2014 onwards regardless whether or not it had passed by the Swiss authorities.

It entails:
- Direct reporting by Swiss financial institutions of the account information to the US authorities (based on a declaration of consent of the account holder) → tantamount to Automatic Exchange of information
- Indirect reporting by Swiss financial institutions of the account holders that have not given their consent + exchange of information based on the double taxation treaty.

FATCA targets all jurisdictions where American taxpayers are account holders. However, there is little room for doubt that Switzerland was the arch-enemy after the SwissLeaks scandal broke out as well as the massive tax avoidance schemes set up by US companies.

Example of Caterpillar's offshore tax strategy.
→ In 2014, the US Senate subcommittee on investigations found that on a 12-year period (2000-2012) US manufacturer Caterpillar managed to shift $8 billion in profits from Caterpillar U.S. to its affiliate in Switzerland.
= This cut Caterpillar’s U.S. tax bill by $2.4 billion during that period.
It negotiated a 4% to 6% effective tax rate with Swiss authorities.

While not directly entering into the scope of FATCA, the ease with which an American company has been able to escape taxation through bank secrecy laws demonstrates the need for the implementation of automatic exchange of information and common reporting standards as proposed by the OECD.

5) Swiss double-tax treaty network

Switzerland has an extended double-tax treaty network. Indeed, double taxation agreements (DTA) are signed with over 80 countries.
Interesting facts :
- While an overwhelming majority of developed countries adopted the OECD model dating from 1977 at an early stage, Switzerland waited until 2009 following a Federal Council decision to base its DTAs on it.
- Even today, many of its treaties are still based on a flawed model preventing from exchange of information and administrative assistance. As of 2014, it had renegotiated its DTAs with 42 countries but most of them were developed countries leaving developing countries powerless to fight against tax evasion and flight of assets in Switzerland provoked by its national taxpayers according to a 2013 Bern Institute's study:

> "*Developing countries are effectively excluded from Switzerland's recent steps towards increased tax transparency. If they seek a new or revised tax treaty with Switzerland, they must be ready to engage in long and tedious negotiations and make substantial concessions with regard to the taxation of Swiss investors*," said Mark Herkenrath, a tax specialist who works for the NGO Alliance Sud, adding that the 2013 University of Bern report confirmed a similar analysis his NGO had carried out in 2010.

- Developed countries also incur losses because of their DTA with Switzerland.
The recent case of the 3-years negotiation between Italian and Swiss authorities on how to tax undeclared assets also proves the difficulty for Switzerland to attain full transparency. The agreement reached preserves Swiss' favoured position for Italian tax dodgers because voluntary disclosure of their secret assets will burden them with a 7 to 12% tax and penalty but does not end bank secrecy on the long-run.

→ It is possible to challenge Switzerland and its DTA network in regard of the new OECD multilateral convention to be released at the end of 2015 (BEPS Action 15) and that will seek to implement an automatic exchange of information standard and for which Switzerland still seems reluctant to subscribe.

6) Freeport: The secret weapon

This is a very serious and of growing concern issue.
Free ports are havens for high net worth individuals and their assets. As long as goods are located within free ports, VAT and customs duties are suspended, even if sold in free ports Goods in Freeport are technically in transit.

It is the shift in their purpose that has encouraged tax evasion.
Indeed, originally, they serve as a transitional storage facility for goods that are meant to be traded at a later stage for example soft goods that have to be labelled.

Now, freeports might as well have become a new instrument for tax dodgers and Switzerland is a fine place for free ports with sites in 10 places across the country including Zurich and Geneva.

Switzerland remains the world's leading gold repository but figures fail to capture the quantities of gold that go straight from runways to the free ports.

The Economist compares freeports in Switzerland to a "parallel fiscal universe". Some facts are of particular concern regarding Switzerland:

- More than €80 bn. worth of high-value added goods are stocked in Swiss free ports.

- There is no VAT, nor transaction tax, nor capital gains tax on transactions taking place through a Free port.

- The Geneva canton owns an 86% share of the Freeport sited on its territory but does not even know the company that pays the canton for the right to serve as the Freeport's landlord. This might also prove that Swiss local authorities have an interest in keeping and increasing Freeport location.

- Open customs warehouses (OCW) are an alternative to Free ports. They are warehouses within Swiss customs territory in which warehouse operators (importers, carriers, transit agents, freight forwarders, etc.) can store their own or third-party foreign goods at approved places.
It is also representing a major risk of tax evasion with high-value added goods stored on a long run with view of asset management and tax avoidance purposes.

- Inspections are too lax in spite of tightened customs legislation enacted in 2009 and critical report of January 2014 issued by the Swiss Federal Audit Office.