6 September 2017

Tax proposal 17 (TP17)

Glossary

Depreciation: Depreciation is undertaken so that the current value of assets can be seen in the financial statements at all times. It involves booking the decline in asset value (as a result of the "wear and tear" or ageing of fixed assets) as a cost from an accounting perspective. As an expense item, depreciation has the effect of reducing taxable profit.

Disclosure of hidden reserves: (see also "Reserves, hidden") A taxable realisation of hidden reserves already occurs under current law if the tax liability comes to an end (e.g. as a result of a move away from Switzerland). Conversely, it is logical to permit a tax-neutral disclosure of hidden reserves generated abroad at the beginning of the tax liability as a result of a move to Switzerland.

If taxation as a status company ends before TP17 enters into force, the disclosure of hidden reserves will be based on the respective cantonal practice. In the case of companies that keep their tax status until TP17 comes into force, the hidden reserves will be set out in a ruling and they will be taxed at a special rate to be determined by the relevant canton if realised in the subsequent five years.

Both the disclosure of hidden reserves when moving in and the end of taxation as a status company are also designated as a step-up.

Equalization measures, vertical: Vertical equalization consists of a transfer from the Confederation to the cantons to create fiscal policy leeway for the cantons and to distribute the burden of TP17 in a balanced manner between the Confederation and the cantons. TP17 will be implemented largely in the cantons and their communes, where it will lead to greater reductions in receipts than is the case for the Confederation. By contrast, the Confederation will benefit from the preservation of tax competitiveness, as it can secure direct federal tax receipts.

BEPS: Base Erosion and Profit Shifting (BEPS) is a project of the OECD (Organisation for Economic Co-operation and Development) and the G20 (group of 20 most important industrialised and emerging market nations). The aim of this project is to tax corporate profits where added value is created. The OECD published the outcomes, including four minimum standards in this respect, in the autumn of 2015.

Beta factors: Profits of companies with cantonal tax status are assigned beta factors and therefore have a lower weighting with respect to resource potential. Due to this preferential taxation, profits flow only in reduced amounts into resource potential. The basis for this is the Direct Taxation Harmonisation Act (DTHA). Beta factors are ascertained empirically on the basis of tax data and are set for a four-year period.

Relief restriction: A relief restriction is to be introduced in the Tax Harmonisation Act with TP17. This ensures that at least 30% of companies' profits are taxed even after the new tax-related special arrangements are applied (patent box and additional R&D deductions). Insofar as the current cantonal practice makes provision for the disclosure of hidden reserves when taxation as a status company ends, this arrangement will also come under the relief restriction.

Family allowances: The term "family allowances" covers both child and education allowances. The cantons determine these allowance amounts. The Confederation merely specifies the minimum rates (child allowances CHF 200 per month, education allowances CHF 250 per month). Each of these minimum rates is to be increased by CHF 30 per month with TP17.

Forum on Harmful Tax Practices (FHTP): The FHTP aims to highlight and prevent harmful tax practices in OECD member states as well as other countries. Switzerland is represented in this body.

The OECD created the FHTP after publishing the report entitled "Harmful Tax Competition: An Emerging Global Issue" in 1998. The FHTP is currently part of the BEPS project under Action 5 and deals primarily with asset requirements for companies and transparency in tax matters.

Counter-financing: The federal finances will be affected by TP17. Although the financial plan for 2019 to 2021 shows structural surpluses for 2020 and 2021, a structural deficit ensues in 2020 when the burden of TP17 is included. From today's perspective, expenditure cuts would thus have to be made when budgeting for 2020 in order to be able to adhere to the debt brake stipulations. Moreover, to prevent an increase in the need for adjustment, additional burdens that are not counter-financed are to be avoided in the federal budget in the years ahead.

Federal profit tax: The federal profit tax applies to all legal entities headquartered or effectively managed in Switzerland. This affects in particular corporations, i.e. companies limited by shares (Aktiengesellschaften), partnerships limited by shares (Kommanditaktiengesellschaften), limited liability companies (GmbHs) and cooperatives, as well as associations, foundations and other legal entities.

Profit tax rate, statutory: This is based on the legally prescribed profit tax rates. At federal level, this is currently 8.5%.

Profit tax rate, effective: As the tax amount can be deducted from the assessment basis, the actual tax payable is reduced. At federal level, it is 7.83%.

Cost compensation: The cost compensation system eases the burden for Alpine and centrally situated cantons, which, for structural reasons, face higher costs for the provision of public goods and services. Contributions for excessive costs are through geographical/topographic cost compensation (GCC) on the one hand, and socio-demographic cost compensation (SCC) on the other. Cost compensation is entirely financed by the Confederation.

Nexus approach, modified: This approach was drawn up by the OECD (see FHTP) in connection with patent boxes. The modified nexus approach is meant to ensure compliance with the principle that the granting of a patent box requires sufficient economic substance on the part of the company in question. According to this approach, profits from patents and similar rights can be taxed at a reduced rate based on the relationship between research and development expenses attributable to the taxpayer (R&D expenses) and total R&D expenses. A supplement (*uplift*) corresponding to 30% of the R&D expenses attributable to the taxpayer is envisaged to compensate for the financing and control particularly of R&D carried out abroad by group companies.

Fiscal equalization: Switzerland's fiscal equalization system regulates financial relations between the Confederation and the cantons. It encompasses the allocation of public tasks on the one hand, and the redistribution of public funds between the Confederation and the cantons, or between the cantons, on the other. Fiscal equalization pursues two primary aims: to reduce cantonal differences in financial capacity and to increase the government's efficiency in the performance of its tasks.

Research and development deductions, additional: This measure is a method for promoting research and development and is widely used internationally. Unlike the patent box, this instrument concerns expenses. With this measure, the cantons can permit an additional deduction on research and development expenses that is up to 50% greater than the actual expenses. The additional deduction is based on research and development personnel costs plus a flat-rate supplement.

Patent box: The patent box is an instrument that is currently used in many states and is accepted by the OECD and the EU under certain conditions. With a patent box, profits from patents and similar rights are taxed at a reduced rate. The patent box proposed by the Federal Council corresponds to the OECD standard for such boxes.

Principal company: International companies centralise functions, responsibilities and risks within the group by product area or market. The parent company in a centralised structure is referred to as the principal company. It typically assumes global responsibility for tasks such as purchasing, the planning of research and development, production planning and management, inventory management and logistics planning, the development of marketing strategy, sales planning and management, treasury and finance, and administration.

Reserves, hidden: Companies regularly have hidden reserves. These arise from either an undervaluation of assets or an overvaluation of liabilities in the balance sheet. The reserves can be formed unavoidably based on maximum valuation stipulations for assets under commercial law or arbitrarily based on excessive depreciation or provisions permitted under commercial law. They constitute taxable profit when realised, e.g. when the assets in question are sold.

Resource equalization: Resource equalization is one of the instruments in the fiscal equalization system between the Confederation and the cantons, and it helps to reduce the differences in financial capacity between the cantons and to preserve tax competitiveness by national and international standards. The procedure is financed by the Confederation and the financially strong cantons. The Confederation finances vertical resource equalization, while the financially strong cantons finance horizontal resource equalization.

Resource index: The resource index forms the basis for resource equalization. It shows the utilizable fiscal capacity of each canton in relation to the Swiss average, whereby the national average resource potential per capita is defined as an index value of 100. Cantons with an index value below 100 are deemed to be financially weak; those with a value of over 100 financially strong.

Resource potential: Resource potential reflects the utilizable fiscal capacity of a canton, and therefore the financial capacity of a canton. This forms the basis for calculating the resource index. It corresponds to the three-year average of the Aggregated Tax Base (ATB), which is essentially based on the direct federal tax assessment basis.

Step-up: See "Disclosure of hidden reserves".

Tax credit, flat-rate: Based on a double taxation agreement, withholding taxes paid abroad are taken into account for Swiss tax with a flat-rate tax credit. This prevents double taxation in an international context.

Tax status, cantonal: Corporations, cooperatives and certain foundations which fulfil a specific function or whose commercial activity is predominantly exercised outside Switzerland can enjoy a special tax status at cantonal level. The Federal Direct Taxation Harmonisation Act (DTHA) distinguishes between different types of status companies:

- **Holding companies** (Art. 28 para. 2 of the DTHA): The principal activity of these companies involves holding and managing financial interests over the long term.

- **Management companies**

    - **Domiciliary companies** (Art. 28 para. 3 of the DTHA): These companies do not exercise any commercial activity in Switzerland and fulfil only management functions.

    - **Mixed companies** (Art. 28 para. 4 of the DTHA): The commercial activities of these companies in Switzerland are of only subordinated importance.

Direct federal tax does not recognise any tax status.

Swiss finance branch: This is the Swiss operating company of a foreign group financing company.

Partial taxation procedure: The partial taxation procedure was introduced as part of the second series of corporate tax reforms in order to reduce economic double taxation. This occurs if dividends are first fully taxed as the profit of a company and are then fully taxed as the income of a shareholder. Under current law, the cantons are free to decide whether they introduce a partial taxation procedure to tax dividends at a reduced rate and how they apply it. However, partial taxation is applicable solely to interests of at least 10%. By now, all cantons have introduced a partial taxation procedure. With TP17, partial taxation should be increased to 70% at federal level (currently: 50% if the interests are held as business assets and 60% if they are held as private assets). In the future, at least 70% of dividends should be taxed in the cantons too. In addition, the arrangements for applying the partial taxation procedure should be harmonised for the Confederation and the cantons.

Transference: Transference is when an individual sells participation rights to a company in which he or she holds a stake of at least 50% ("sale to oneself"). Under current law, this act is subject to income tax if participation rights of at least 5% are sold. It has turned out in practice that this 5% threshold is unwise, as it can lead to tax-free equity sales worth millions that are triggered solely by tax planning considerations. It should thus be abolished with TP17, with the result that a "sale to oneself" always leads to taxation. At the same time, this would also limit the repercussions of the capital contribution principle.

Corporate tax reforms I-III: The earlier series of corporate tax reforms addressed different issues and involved different areas of focus:

- The first series of corporate tax reforms came into force in 1998. It included improving Switzerland's appeal as a location for holding companies, eliminating capital tax and introducing a linear profit tax rate.

- The second series of corporate tax reforms was accepted by the electorate on 24 February 2008 and was brought into force between 2008 and 2011. Its core elements involved alleviating the burden of double taxation, reducing taxes detrimental to a company's asset base, providing relief for partnerships and applying the capital contribution principle.

- Swiss voters rejected the third series of corporate tax reforms on 12 February 2017. However, because corporate tax reform remained urgently needed, work commenced immediately on a new corporate taxation reform proposal, called tax proposal 17 (TP17).

EU Code of Conduct: The Code of Conduct for Business Taxation (CoC) was adopted by the Council of EU Economics and Finance Ministers (ECOFIN) on 1 December 1997. The Code of Conduct is not a legally binding instrument. It obliges EU member states at a political level to rescind any existing tax measures that could be classed as harmful tax competition and to pass no further measures of this kind in the future.