Swiss Referendum on Corporate Tax Reform Too Close to Call

By

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Days shy of a referendum on whether to scrap the preferential tax regimes granted by Switzerland's cantons to multinational companies, the outcome remains unclear, but tax professionals say a no vote won't put an end to the issue because EU countries are adamant that the special treatment has to go.

The corporate tax reform measures, referred to as CTR III, were passed by the Federal Assembly in June 2016. If approved in the referendum on February 12, the reforms will eliminate Switzerland's special cantonal tax incentives favoring foreign-source income and foreign companies over domestic businesses. (Prior coverage .) The European Commission claims that the regimes violate the country's commitments under an agreement signed with the EU in 1972 by providing incentives for multinational companies to locate in Switzerland. In 2014 the Swiss Federal Council reached agreement with the EU to end the cantonal regimes and replace them with laws that are in accord with generally accepted international standards. In exchange, the EU said its member states would remove countermeasures targeted at the cantonal regimes. (Prior coverage .)

The CTR III reforms include a patent box, which would allow companies to reduce the tax base on income derived from patents and comparable rights by up to 90 percent. Another incentive would let cantons authorize corporate deductions equal to 150 percent of qualifying research and development expenditures. A third reform would allow companies to take deemed interest deductions for equity capital in excess of what are considered normal levels.

The new benefits possible under CTR III won't completely compensate for those that are now available to multinational companies under the cantonal tax regimes. Concerned about the possible loss of foreign companies, and the jobs they provide to local residents, some cantons have passed legislation reducing their corporate tax rates for all businesses. The canton of Geneva announced plans in August 2016 to slash its corporate tax rate from 24 percent to 13.49 percent, while Vaud approved a referendum in March to cut its corporate rate from 21.65 percent to 13.79 percent. (Prior coverage .) The Federal Council has also said it will increase the cantons' share of direct federal tax receipts.

Thierry Obrist of the University of Neuchatel said that while many cantons have announced reductions in their corporate income tax rates, not all have implemented the reductions.

Status Quo Not an Option

Frank Marty, head of finance and taxes at the Swiss Business Federation, said the upcoming referendum is unlike others because voters will not be confronted with the customary decision of whether to adopt a new course of action or to maintain the status quo. "Not this time," Marty said in a January 31 posting on the federation's website. "Switzerland's tax system faces criticism and the cantons will be forced to abolish a tax regime that is no longer acceptable internationally, regardless of the vote outcome," he said. "Because the status quo is simply no longer an option, the federal government, parliament, and cantons have drafted a widely supported compromise. With this, tax revenue of more than CHF 5 billion [around $5.03 billion] and more than 150,000 jobs can be secured."

The Social Democratic Party and the Green Party both called for the referendum, saying taxpayers will have to absorb the cost of what they claim will be billions of Swiss francs in new benefits for large companies and their shareholders. In a posting on its website, the Social Democratic Party referred to the reforms as opaque and a scam, the costs of which are impossible to calculate. "Behind this technical jargon are opaque tax tricks, which only financial or tax advisers can understand," the posting said. "Some companies and their major shareholders, including pension funds or Qatari sheiks, will reap billions. The bill will be addressed to the middle class, workers and 'normal' taxpayers; in other words, all of us!"

Christian Keuschnigg of the University of St. Gallen said supporters of CTR III hope the new tax incentives will help the cantons hold on to many of the multinational firms that could easily move elsewhere. "Discriminating tax privileges are replaced by non-discriminating tax incentives, which are in place in many EU countries as well," Keuschnigg said in an email. "The principle objection is that [cantons] will lose some tax revenue -- around CHF 2 [billion] to 4 billion, or roughly 1.5 percent of total tax revenue -- so that [increased] other taxes or [lower] government spending will put a burden on private persons and hurt lower- and middle-income people."

Obrist said that besides keeping Swiss tax law in line with the OECD's base erosion and profit-shifting project, supporters also claim that ending the cantonal tax regimes will avoid any problems with state aid violations of EU law. Under the Treaty on the Functioning of the European Union, member states are not allowed to confer on businesses selective advantages that are not available to similarly situated companies. To violate state aid law, the aid must also distort both trade and competition within the EU. While Switzerland is not a member of the EU, it is a member of the European Free Trade Association and is subject to the European Economic Area agreement, which requires compliance with EU state aid law.

Keuschnigg said all sides agree that the special tax regimes must be ended because a failure to act would expose the cantons to severe pressure from the EU. He said up to 80 percent of corporate tax revenues in some cantons come from multinational companies benefiting from the controversial regimes. "These cantons cannot afford to do nothing, as these firms are mostly active abroad and very mobile and won't accept to simply double their tax liabilities," Keuschnigg said.

Whether many multinationals would actually abandon Switzerland is unclear because they would presumably do so for tax reasons only if they could secure a significantly lower rate in another country that is sufficiently stable and satisfies other corporate location criteria. According to a recent study by KPMG, Switzerland's average combined maximum federal, cantonal, and municipal tax rate of 17.8 percent occupies a "lower middle position" in a global comparison of country tax rates. None of the major EU countries offers a lower rate, and the home countries of many of the multinationals with operations in Switzerland, including Japan and the U.S., have far higher nominal rates of tax. (*See* goo.gl/WVs9Yo.)

Obrist said some of the negative reaction to the reforms is based on a misconception. "It seems that many people do not understand that the decrease in corporate income tax is not covered by the reforms," Obrist said. "The definition of the corporate income tax rate will stay a cantonal power. And the patent box is BEPS compliant because it is based on a nexus approach."

Lengthy Process if Referendum Loses

Obrist said lawmakers will have to go back to the drawing board if the tax reforms are voted down. "We will lose time -- maybe creditability too -- and will have to come up with a new draft," he said.

An academic who asked not to be identified said the legislative process in Switzerland is relatively slow and that a new draft of reforms that would satisfy the EU could take at least one to two years. "The risk of reprisal is for Switzerland to be put on blacklists and . . . the refusal of deductions for payments made to Swiss companies benefiting from the [challenged] tax regimes," he said.

Keuschnigg pointed to nontax factors that should contribute to the support for CTR III, including the relative strength of the Swiss franc and increasing uncertainty over access to EU markets, both of which he said erode the country's attractiveness to multinational corporations. "Instead of cutting tax rates too much, it seems better to reduce the tax load only if firms step up R&D efforts, [such as providing] tax incentives for innovation, and strengthen their shock resistance by increasing equity instead of debt financing, thanks to the proposed new deduction of interest on equity," he said.

Keuschnigg said it's hard to predict which side will prevail in the referendum. "An initial lead of the supporters has largely disappeared by now," he said. "It's a government proposal broadly supported by industry. The referendum will be extremely tight."