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TRAF: Cantonal strategies in the competition to attract businesses

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Cantonal strategies in the competition to attract businesses

If the Tax Reform and AHV Financing bill is accepted by the electorate, a fundamental restructuring of corporate taxation in Switzerland will be the consequence. The privileged tax regimes that apply to status companies will be abolished. On the other hand, innovative companies will benefit from internationally accepted fiscal support measures. There will be significant cantonal differences in the structuring of these new tax instruments, however. In addition, a number of cantons are set to reduce their ordinary corporation tax rates sharply.

Tax Reform and AHV Financing (TRAF)

On May 19, 2019, the Swiss electorate will vote on what is currently one of the most important reform projects in Switzerland. The Federal Act on Tax Reform and AHV Financing (TRAF) is designed to create a tax system that complies with international rules on the one hand while remaining competitive on the other, thereby preserving Switzerland's appeal as a business location. This has entailed the original "Tax Proposal 17" (TP17) being expanded by parliament with social policy adjustments in favor of the social security system. If the bill is accepted, first measures could be implemented right after the referendum, although the majority of measures are not expected to enter into force until January 2020.

Abolition of tax privileges for status companies

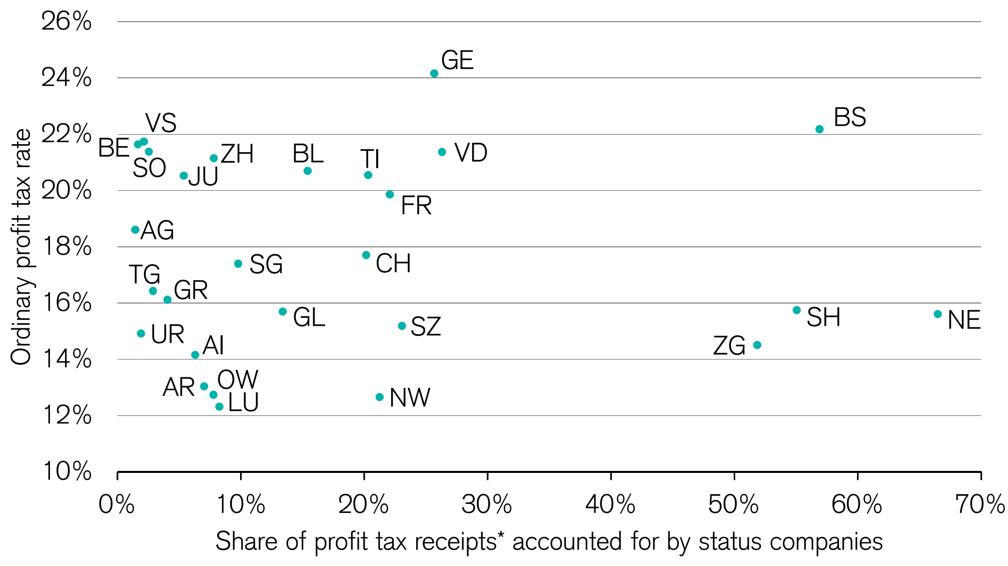
A key element of the reform is the abolition of privileged taxation for so-called "status companies" (holding, domicile and mixed companies). As things stand, companies that generate most of their sales and costs outside Switzerland abroad benefit from reduced tax rates, and in some cases even tax exemptions. For example, holding companies – whose primary purpose is to hold stakes in other capital companies – do not pay any profit tax at cantonal level, and in some cantons benefit from lower capital tax as well. In the future, this unequal tax treatment of domestic and foreign income will no longer be permissible.

Reform with far-reaching repercussions

Today's status companies are of considerable importance to Switzerland. Over the period 2012–2014 they paid an average of some CHF 3.6 billion of profit tax each year – around half the Confederation's total profit tax receipts. In the case of the cantons and the municipalities, status

Status companies are of great economic significance

Relevance of status companies benefiting from privileged taxation measured through their share of profit tax receipts 2012–2014, ordinary profit tax rate 2018



Source: Federal Tax Administration, KPMG, Credit Suisse

* Canton and municipality level, including share of direct federal tax

companies accounted for around 20% (or some CHF 2.1 billion) of corporate tax receipts (cf. Figure on p. 3) – in the cantons of Neuchâtel, Basel-City, Schaffhausen and Zug, the equivalent percentage was more than 50%. Moreover, status companies play a crucial role when it comes to innovation in Switzerland, accounting for some 48% of private company expenditure on research and development (R&D).

Support for research and development

As a result of the abolition of privileged tax regimes for status companies, the same tax rules will apply to all companies in the future. In order to preserve Switzerland's appeal as a business location, new and internationally accepted measures are to be introduced at cantonal level to support innovative activities. For example, all cantons must introduce privileged tax treatment for profits from patents ("patent box") – although the amount of tax relief may not exceed 90% of the profit in question. Cantons will also have the option of making provision for additional deductions for R&D expenditures. Finally, a canton may grant an interest deduction for self-financing as long as the effective profit tax burden in the Cantonal capital amounts to at least 18.03% – as things stand, only Canton Zurich is likely to fulfill this condition. Overall, however, the tax relief of these three instruments may not exceed the threshold of 70% ("relief restriction"), i.e. every company must be taxed on at least 30% of its taxable profit prior to the application of the special rules.

Increase in dividend taxation and the cantons' share

To counterfinance this reform, a number of measures are envisaged, including a higher rate of income tax for revenue from participations: Dividends will in future be taxed at 70% at federal level (currently 60% for private assets and 50% for commercial assets), and at a rate of at least 50% at cantonal level (currently lower in four Swiss cantons). Furthermore, the cantons' share of direct federal tax revenue is to rise to 21.2% (currently 17%), not least with a view to giving the cantons greater fiscal policy leeway to reduce their ordinary tax rates.[1]

Major cantonal differences in the design of the new tax instruments

Within these statutory parameters, the cantons will have the opportunity to put together their preferred overall package of ordinary corporate tax rates and customized fiscal policy measures. A canton's fiscal policy strategy will depend on the significance of status companies in that canton, the relevance of corporate taxation for the canton's appeal as a business location, the intensity of intercantonal and international tax competition, and the fiscal leeway available to each canton. The following table provides an overview of the current intentions of the Swiss cantons when it comes to the design of tax instruments.

Zurich, Obwalden and Aargau particularly exploit fiscal leeway with the new instruments

Overview of cantonal design of key new tax instruments, as at 13.3.2019

	Relief restriction	Patent box	Additional R&D deduction	Dividend taxation exemption	Interest deduction on equity capital
ZH	70%	90%	50%	50%	✓
OW	70%	90%	50%	50%	✗
AG	70%	90%	50%	40%	✓ if permissible
TI	70%	90%	50%	30%	✗
JU	70%	90%	50%	30%	✗
SZ	70%	90%	50%		✗
ZG	70%	90%	50%		✗
NW	70%	90%	0%	50%	✗
SH	70%	90%	0%	40%	✗
GR	70%	70%	0%	30%	✗
TG	70%	40%	0%	30%	✗
LU	70%	10%	0%	40%	✗
AR	50%	90%	50%	40%	✗
SO	50%	90%	50%	25%	✗
SG	50%	50%	50%	30%	✗
UR	50%	30%	0%	30%	✗
AI	50%	30%	0%		✗
BS	40%	90%	0%	20%	✗
NE	40%	20%	50%	30%	✗
VS	34%	90%	50%	40%	✗
FR	20%	90%	50%	30%	✗
BL	20%	90%	20%	50%	✗
GL	10%	10%	0%	30%	✗
GE	9%	10%	50%	40%	✗
BE		Implementation not yet known			
VD		Implementation not yet known			
Maximum permissible	70%	90%	50%	50%	

Source: BDO, cantons, Credit Suisse

[1] In addition to the measures cited above, the reform includes further tax measures for both companies (adjustments to capital tax, rules on the disclosure of hidden reserves, etc.) and shareholders (restrictions in respect of the capital contribution principle). Moreover, an adjustment of fiscal equalization between the cantons is envisaged. More detailed information can be found at: https://www.efd.admin.ch/efd/en/home/dokumentation/legislation/abstimmungen/staf.html.

Trend toward competition via lower ordinary tax rates persists

Despite the newly introduced tax privileges, on balance, the cantons will have less scope to reduce the basis for assessment, and many companies will not be able to profit from the proposed new tax instruments. In order to remain attractive in the tax competition, the majority of Cantons are therefore planning to reduce their ordinary corporate tax rates. In other words, the global trend toward greater tax competition through lower ordinary tax rates is persisting.

Preventing the migration of status companies

Cantons that currently have high ordinary profit tax rates – such as Geneva, Vaud, and Basel-City – are under particular pressure to act, as status companies account for a significant proportion of taxable profits, and the income of these companies is only partially captured by (one of) the new tax policy measures (cf. Figure, p. 3). Unless these cantons reduce their ordinary profit tax rates significantly, there is a danger of more mobile companies migrating to other cantons or abroad for tax reasons. At the same time, such cantons can probably reduce their ordinary tax rates without risking a slump in tax receipts, as the average effective profit tax rate when viewed across all companies is already well below the ordinary tax rate.

Intercantonal tax competition also putting pressure on cantons with few status companies

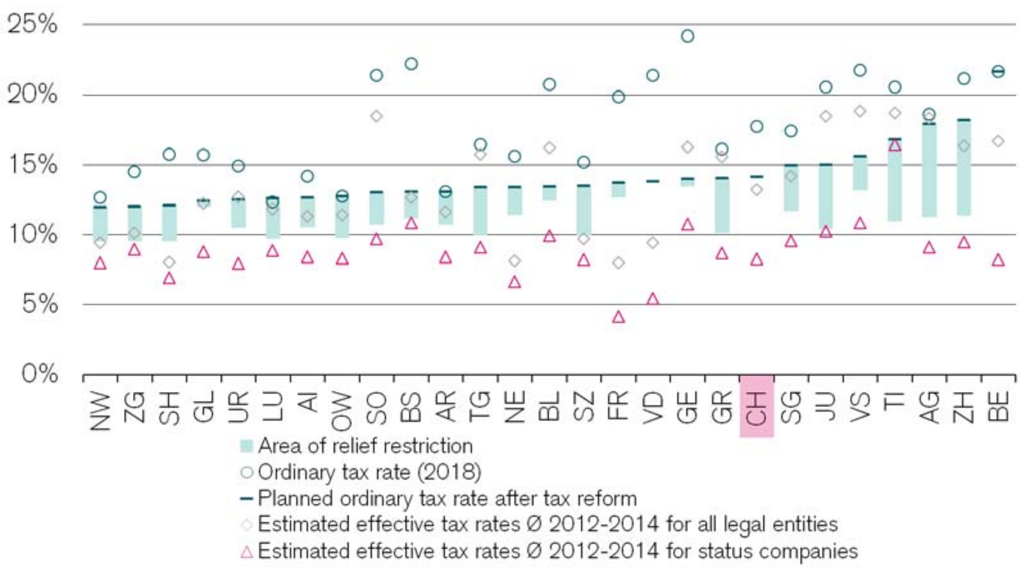
For cantons in which status companies play only a minor role, the migration of such companies obviously poses a lesser risk. Nonetheless, these cantons too will have to rethink their corporate tax strategy, as intercantonal tax competition is likely to intensify as a result of tax reductions in other cantons. These cantons find themselves in a difficult situation, as a similar reduction in their ordinary tax rates would result in a sharp decline in tax receipts from ordinary taxpaying entities. The preservation of tax competitiveness – in respect of both local status companies and ordinary companies – will come at a higher cost in such cantons.

Large corporate groups will typically pay more tax than today, SMEs less

The figure below gives an impression – based on the latest knowledge available – of how the tax burden for legal entities is likely to develop in the different cantons.[2] Companies currently taxed at the ordinary rate (circles) are likely to pay less in the future, firstly because the ordinary tax rates in some cantons will decline (hyphens), and secondly because they may benefit from the newly introduced tax instruments, which means they should be able to reduce their tax burden even further (within the turquoise-colored relief restriction area). Generally speaking, today's status companies will have to pay somewhat more tax: During the period 2012–2014, the tax burdens of

Ordinary tax rates to be reduced on a broad front, existing status companies to pay somewhat more tax in future

Effective profit tax rates for companies subject to ordinary and privileged taxation and average tax rate for all legal entities, planned ordinary tax rate after tax reform and area of relief restriction according to cantonal authorities



Source: Federal Tax Administration, KPMG, cantons, Credit Suisse

[2] The proposed tax reductions will typically still have to be approved by the cantonal electorates. Only in Canton Vaud and Canton Basel-City has the corporate tax reform process already been completed.

these companies (triangles) were significantly below the planned ordinary tax rates[3] And even in the event of full exploitation of available tax relief up to the maximum permitted by the relief restriction, the tax burden will rise at least slightly in all cantons.

Significant repercussions for locational quality

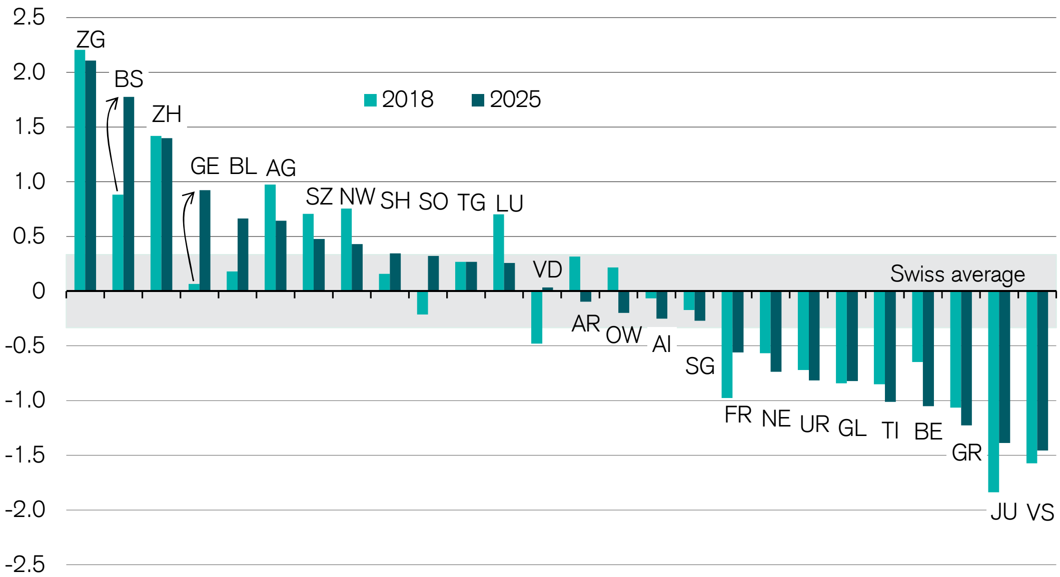
Subject to acceptance by the Swiss people, the corporate tax reform and the cantonal adjustments will have the effect of "reshuffling the cards" in the cantonal competition for companies. In other words, one of the seven components of Credit Suisse's Locational Quality Indicator is set to change significantly. Based on the intended corporate taxation adjustments of the cantonal governments, which in many cases would be implemented in stages between now and 2025, we looked into the future at the end of 2018 to predict locational quality in 2025.[4] This entailed recalculating the locational quality sub-indicator "Tax attractiveness for legal entities" , which measures the burden imposed by ordinary profit and capital taxes, but not the planned design of the new tax instruments. It also involved taking into account changes in the "accessibility" indicators as a result of the completion of the New Railway Link through the Alps (NEAT) by 2020. As various cantons have made further changes to their planned tax strategies in the meantime, we have now updated our hypothetical ranking once again.

Locational quality 2025: Zug defends top spot, Basel-City overtakes Zurich and Aargau

In this hypothetical Locational Quality Indicator (LQI) for 2025, the Canton of Zug remains top of the rankings (cf. Figure). Following the reduction of the profit tax burden to 13.04%, a change that was approved by its cantonal electorate in February 2019, Canton Basel-City is the biggest gainer in our scale, which is based on the latest information. It clearly displaces Canton Zurich (planned profit tax burden of 18.19%) from second place – a position it has held ever since our rankings began – down into third place. Another significant improver is Canton Geneva (planned profit tax burden now 13.99%), which would advance as many as nine places up the rankings. Basel-Country and Solothurn both move up six places, as these cantons too are planning to cut profit tax rates sharply (to 13.45% and 13.0% respectively), as well as looking to reduce capital taxes. Canton Aargau, which occupies third place in 2018, is set to slip back to sixth place in 2025 if it presses ahead with its planned reduction of the profit tax rate to 17.9% and capital tax rate to 0.075%. After years of stability, there are now set to be changes at the bottom end of the rankings too: With a profit tax rate of 15%, Canton Jura is set to replace Canton Valais in bottom place.

Locational quality of Swiss cantons in 2018 and 2025 – a comparison

Locational Quality Indicator (LQI), synthetic index, CH = 0, 2018 and recalculation of sub-indicators of accessibility and tax burden for legal entities (as at 13.03.2019)



Source: Credit Suisse

[3] In the case of certain cantons, the average tax burden was below the regular federal tax rate. This is attributable to tax relief measures granted in the context of the New Regional Policy (formerly the "Lex Bonny"). A canton may grant tax relief to newly-founded companies that are deemed to serve its economic interests for a maximum of ten years. In addition, the Confederation may provide additional support in structurally weak regions by granting a reduced rate of direct federal tax. In certain situations, a status company may then end up paying no cantonal profit tax and reduced direct federal tax. This instrument was last revised in 2016.

[4] Cf. "Locational Quality 2025: Outlook after the Tax Reform", Credit Suisse, November 2018.

Relative benefit of low corporate taxes set to decline

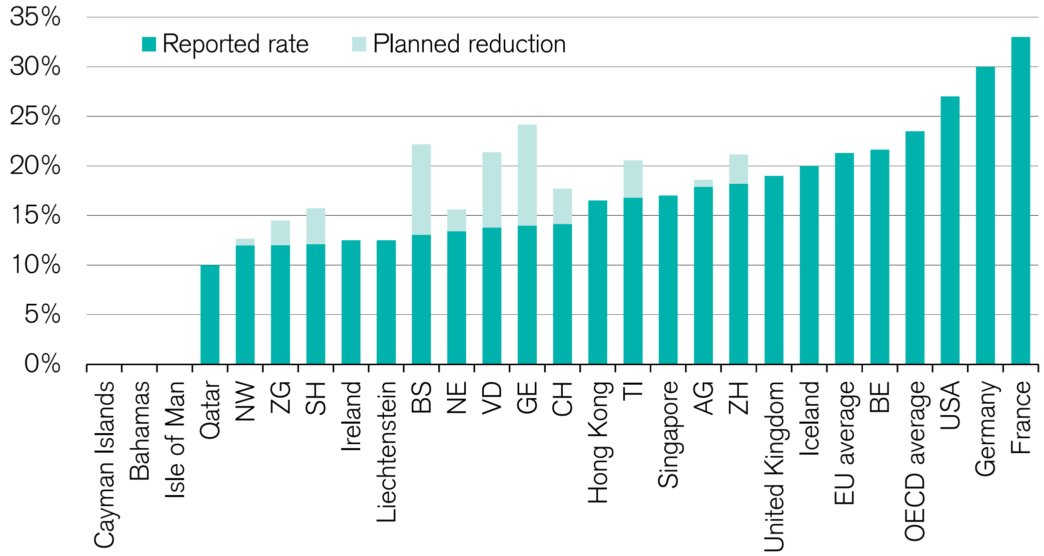
The planned reductions in corporate tax rates will increase locational quality. Due to the relative view of locational quality, however, cantons can still slip down the Locational Quality Indicator rankings despite introducing tax relief measures. The current leaders in the sphere of corporate taxation will lose at least some of their relative advantage, as the differences will narrow overall, while a number of cantons are seeking to position themselves even more attractively from a tax standpoint in the future. All central Swiss cantons and the two cantons of Appenzell are set to experience a decline in their Indicator figures. The greatest ranking slump of all – a full six places – would be suffered by Canton Appenzell Ausserrhoden. Despite a significant reduction in its capital tax rate, Canton Obwalden would move five places down the rankings even if it were to leave its profit tax rate unchanged; the same decline would affect Canton Lucerne, which is envisaging a modest rise in its profit tax rate to 12.6% in order to balance its budget. With the local electorate having rejected the cantonal tax legislation revision in November 2018, Canton Bern would fall to the last place on the corporate tax ranking and thereby suffer a decline of four places – down to 23rd place – in the Locational Quality Indicator.

Switzerland scores highly on other locational criteria too

Switzerland emerges as one of the most attractive business locations in numerous global rankings.[5] The country's key strengths include its political stability, high-quality infrastructure and education institutions, harmonious labor relations, and healthy public finances. One negative aspect – and presumably an obstacle to attracting businesses – is the comparatively high cost of labor and land, a situation that has been further exacerbated in recent years by the appreciation of the Swiss franc. That said, Switzerland does have two notable advantages from a cost perspective: Capital costs (i.e. the level of interest rates) are low, as is the tax burden. In view of the prospective reductions in ordinary profit taxes, a majority of Swiss locations are expected to remain attractive from a tax standpoint in the future too – rates of between 12% and 14% are regarded as attractive in an international comparison. However, the significance of the tax burden is likely declining when it comes to choosing a business location, as there is evidence of general harmonization in this area.

Swiss locations attractive from a tax perspective in an international comparison too

Maximum profit tax rates, CH: selected canton economic centers, planned reduction of ordinary profit tax burden compared to 2018 as a result of tax reform



Source: KPMG, cantons, Credit Suisse

[5] Cf., for example, the Global Competitiveness Index of the World Economic Forum and the Business Environment Ranking of the Economist Intelligence Unit.

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