

## Lake Geneva Regional Study

February 2016

Swiss Issues Regions

# Corporate Taxes: Vaud and Geneva under Pressure



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### Editorial deadline

January 29, 2016

### Printed by

Mengis Druck AG, Visp

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## Editorial

Dear Readers,

We are pleased to present a new study on the «Lake Geneva Region», in which our economists analyze the region's prospects in light of the Corporate Tax Reform III. The study seeks to add value for private and corporate clients as well as decision-makers in the world of politics and business, and also to encourage debate. As a bank with strong roots in the French-speaking part of Switzerland, we believe it is important to understand the regional economy and its future prospects in detail. It is our hope that this publication will contribute to the economic success of the region.

The Swiss tax system faces major changes. As home to numerous global corporations, the Lake Geneva region will be particularly heavily affected. The cantons of Vaud and Geneva currently make extensive use of the privileged taxation of foreign company profits, which is to be abolished. The planned reform requires that locations use alternative means to retain their appeal to global firms. The governments of both cantons have therefore announced that they will be making changes to their tax policies. The new developments carry a risk that some of the companies currently based there will relocate abroad. On the other hand, new companies are likely to move to the Lake Geneva region. The reforms are still going through the political process, meaning it is too early to provide a detailed illustration of the consequences for the cantons and their public finances. This study nevertheless aims to assess the impact based on what we currently know.

Credit Suisse's associations with the cantons of Geneva and Vaud go back a long way: it was in 1906 that the former Schweizerische Kreditanstalt (SKA) opened its first office in French-speaking Switzerland at Geneva's Place Bel-Air. The Geneva presence of Schweizerische Volksbank, which merged with SKA in 1993, dates back as far as 1896. With its acquisition of Société Suisse de Banque et de Dépôts in 1920, Credit Suisse also established a presence in Lausanne on the city's Rue du Lion d'Or. Today, Credit Suisse is represented in the cantons Geneva and Vaud by more than 20 branches. In addition, there are specialized teams for international clients, commodity financing, credit business, as well as for the development of IT services.

Our regional associations within the banking industry and diverse commitments in the world of culture, sport and society at large are tremendously important to us. We are proud to be able to count so many Geneva and Vaud private individuals and businesses among our valued clients.

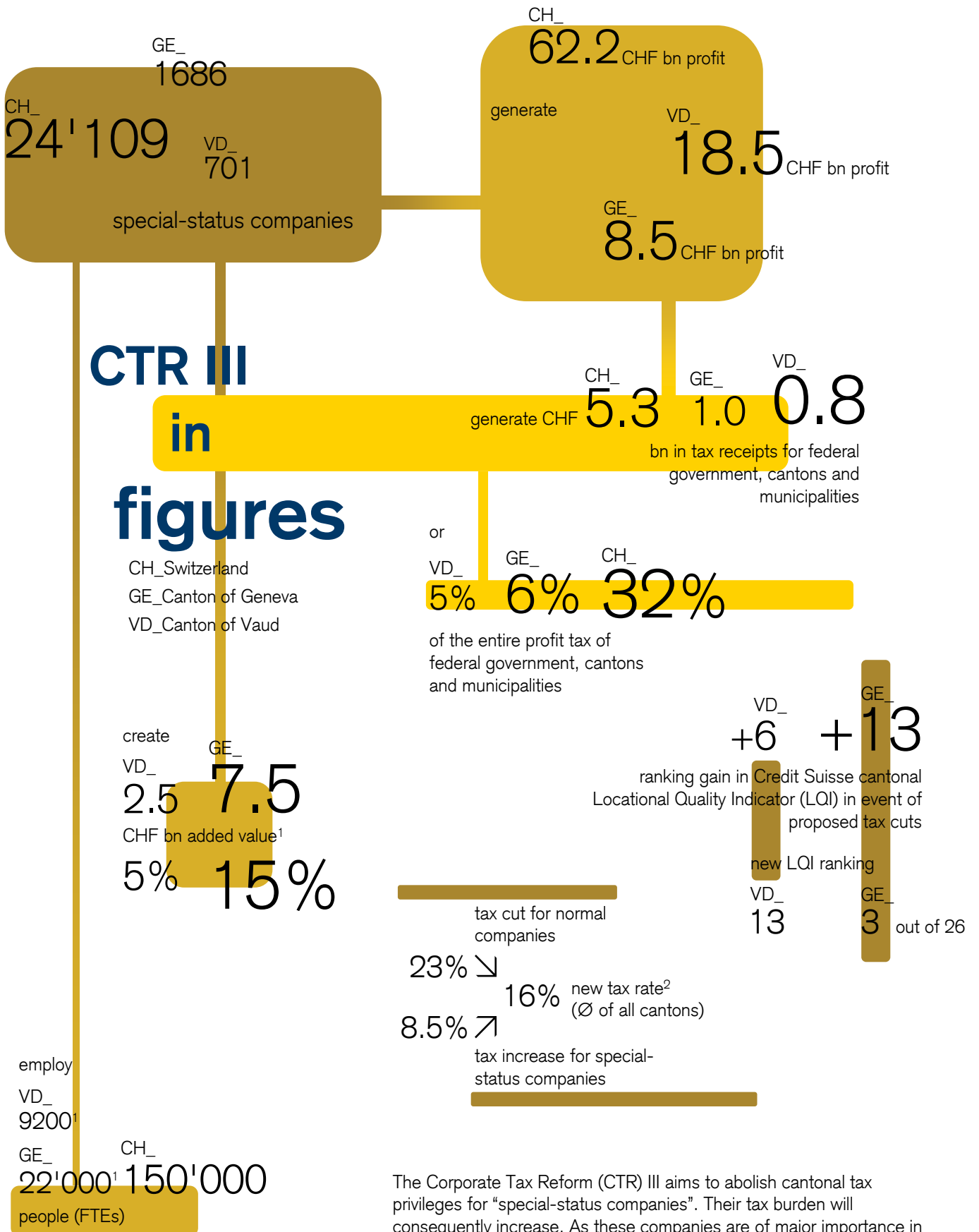
We hope this study provides you with valuable insight.



Pascal Besnard  
Head of Geneva Region



Jean-Luc Rochat  
Head of French-Speaking Switzerland Region



The Corporate Tax Reform (CTR) III aims to abolish cantonal tax privileges for “special-status companies”. Their tax burden will consequently increase. As these companies are of major importance in economic terms, numerous cantons are likely to lower their standard rate of profit tax in order to retain their appeal to such firms.

<sup>1</sup>excludes holding companies <sup>2</sup>estimate Sources: FTA, FDF, Créa, Credit Suisse

## Corporate Taxation | International

# OECD Sets New International Standards for Taxation

**With the «Base Erosion and Profit Shifting» (BEPS) action plan, the OECD and G20 intend to combat «aggressive tax planning». Switzerland is planning its Corporate Tax Reform (CTR) III in response.**

### Tax laws date from pre-globalization era

The business world has created globally connected value chains, yet tax laws are determined at national level with only negligible coordination. Double taxation agreements and specific tax breaks are usually agreed at bilateral level only, or are confined to specific groups of countries. Assessment bases, tax privileges and the treatment of investment, income from intellectual property, debt interest and dividends, for instance, differ from country to country. The taxation of profits from global value chains is extremely complex given that the place where the value is created and the applicable tax legislation are often difficult to determine. By contrast, Switzerland's cantons have largely harmonized their tax laws in formal terms but compete with one another on tax levels.

### OECD and G20 calling for global minimum standards

Global corporations have the opportunity to adjust their legal structures and internal payment flows in such a way that the tax burden is kept as low as possible. When doing so, their result does not necessarily need to match operational structures and the flow of goods. Skilful combination of various tax laws enables the overall amount of tax payable to be reduced sharply – and is totally legal. Multinational firms make extensive use of such opportunities. However, the Organisation for Economic Cooperation and Development (OECD) and G20 countries have criticized this as «aggressive tax planning». It is impossible to determine the precise scale of the revenue shortfall at present. According to OECD estimates, tax offices worldwide lose 4-10% of the tax receipts «owed to them» – or USD 100-240 billion annually – as a result of such optimization measures. These organizations cite numerous examples of non-taxation or low taxation due to the very specific solutions adopted by individual companies. The OECD and G20 believe the current situation is detrimental to countries, taxpayers and the corporate sector. The OECD started its «Base Erosion and Profit Shifting» (BEPS) action plan in 2007, and published its final report in fall 2015.

The BEPS action plan contains 15 measures and pursues four main objectives:

#### 1. Avoidance of double non-taxation or low taxation of profits

Cross-border payment flows can be combined in such a way that the result is low taxation or even «double non-taxation». The OECD terms this «treaty shopping». One example is the structure known as a «double Irish with a Dutch sandwich» ([see chart](#)). Due to the high and above all globally applicable taxation of profits, US firms in particular have an incentive to use such solutions.

#### 2. Transfer pricing and profit allocation centered on the place of value creation

Through skilfully chosen intra-group transfer pricing for flows of goods and services, profits can be shifted to countries with a low tax burden. The BEPS action plan requires that profits are incurred at the place where value was actually created. At the same time, transfer prices should be based on market prices.

#### 3. Rules on increasing transparency

The combating of profit-shifting often fails because the countries involved have no knowledge of the tax payments made by multinational companies in other countries. The BEPS action plan aims to make country-specific financial statements compulsory. It will also become mandatory for company-specific «tax rulings» – agreements with countries on tax payments – to be disclosed to the tax authorities concerned.

#### 4. Changes to the definition of operating facilities

This is designed to prevent methods based on the artificial separation of business activities and intermediation of commission agents.

**OECD wants level playing field**

These four key thrusts are supplemented by regulations regarding value added tax in e-commerce, arbitration proceedings in the event of conflicts, peer-to-peer monitoring to detect «harmful tax models» and other technical measures. Thus the BEPS action plan is aimed at standardizing rules and assessment bases for corporate taxation. What the OECD is explicitly not seeking to do is to harmonize the level of tax rates, which continue to be decided by individual governments.

**Privileges for research and development expenses**

Tax privileges for research and development (R&D) are one of the few exemptions allowed under the BEPS action plan. Besides deductions for R&D expenses, profits from intellectual property may be given preferential tax treatment through a «patent box». The OECD is tending toward a version that, unlike for instance the «royalty box» currently used in the canton of Nidwalden, excludes income from royalties and trademark rights. Patent boxes are already coming in for criticism, however. From today's perspective, therefore, it is uncertain whether the model will survive in the long term.

**Current Swiss tax practice clashes with BEPS**

The driving force behind the BEPS project is the G20 – the 19 biggest industrial nations plus the European Union, which tend to be among the victims of today's tax competition. By contrast, Switzerland along with other smaller, low-tax countries have been able to position themselves as attractive locations – in part using the forms of taxation that will be outlawed in future. The OECD project calls into question sovereignty over the form of taxation: the BEPS action plan directly targets the preferential taxation of the foreign profits of cantonal special-status companies and the structuring of the royalty box in the canton of Nidwalden.

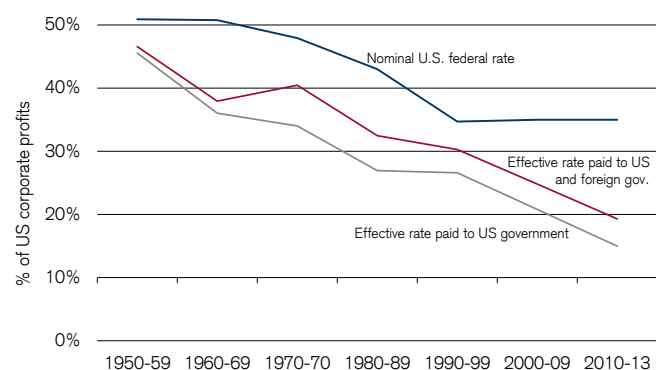
**Will all countries be BEPS-compliant?**

Switzerland is a member of the OECD and has been actively involved in the BEPS project. In principle, it is free to decide whether to implement the recommendations and minimum standards. If it stays on the sidelines Switzerland and the companies affected are likely to be hit with sanctions, meaning this is scarcely a viable option. In response to the BEPS action plan, Switzerland is planning its Corporate Tax Reform III to ensure that Swiss tax laws comply with the new international requirements. The other 33 members of the OECD are also expected to implement the recommendations of the BEPS action plan. But whether this really leads to a level playing field will only become clear when all countries have responded to the action plan. Given the financial significance of corporate taxation, it is quite conceivable that new legal loopholes will develop or that individual countries will deliberately evade the necessary reforms. If Switzerland is to retain its appeal amid international tax competition, it is therefore vitally important for the other countries to implement the BEPS action plan equally systematically.

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**US tax laws can be avoided by legal means**

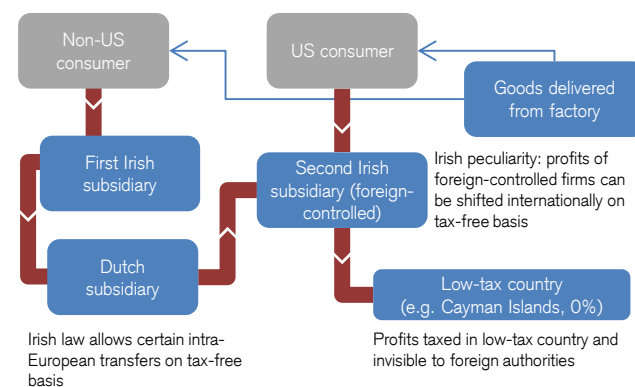
Estimated effective tax burden of US companies



Source: Gabriel Zucman: The Hidden Wealth of Nations (2015)

**Double Irish with a Dutch sandwich**

Red: cash flows, blue: flow of goods



Source: Credit Suisse, based on the New York Times

## Corporate Tax Reform III

# A Major Reorganization

The privileged taxation of companies that predominantly generate their income abroad is to be abolished. Instead, innovative firms are set to benefit from internationally accepted preferential regimes.

### Corporate Tax Reform (CTR) III

The CTR III is one of the main reform programs in Switzerland at the moment. It is designed to bring Swiss corporate taxation into line with international standards, defined among other things by the OECD and G20 Base Erosion and Profit Shifting or «BEPS» project. The Federal Council set out the parameters of the reform in June 2015. The proposals are currently the subject of parliamentary deliberation (see chart). Assuming swift agreement by both chambers and the absence of a referendum, the law could come into effect at the start of 2017 and become part of cantonal law by 2019.

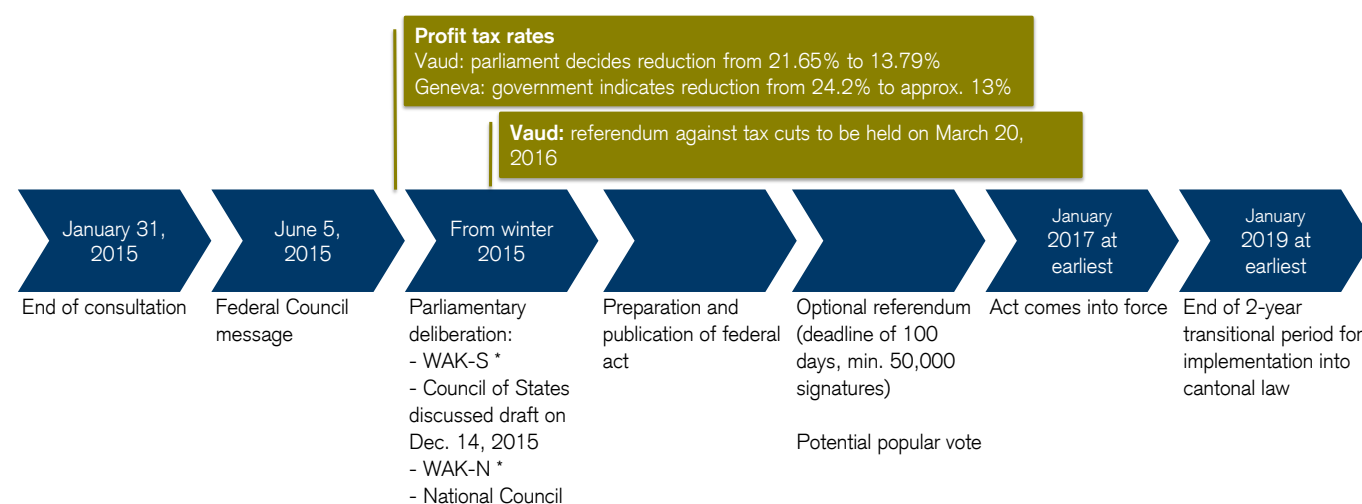
### Abolition of cantonal tax privileges

The central element of the reform is the abolition of privileged taxation for holding and management companies. At present, companies whose sales and costs are to a large extent incurred abroad benefit from considerable tax privileges or even tax exemptions. Thus holding companies whose primary purpose is to invest in other companies pay no profit tax at cantonal level and reduced taxes on capital, depending on the canton. In future, this unequal taxation of income generated in Switzerland and abroad will no longer be permitted.

### Encouraging research and development

Instead, tax policy measures that are also permitted abroad are to be introduced at cantonal level. In future, therefore, it will be possible to shift income from patents developed in Switzerland into a patent box and for it to be taxed at a lower, cantonal level. However, this will only be permissible if the research and development was actually undertaken in Switzerland: the share of domestic costs in the total cost of developing the patent will determine the extent of tax privileges («modified nexus approach»). Some of the cost of financing and monitoring research performed abroad can likewise be taxed on a privileged basis. Besides these so-called output incentives, companies may be granted deductions for research and development expenses (input incentives). Finally, a reduction is envisaged in the capital tax on equity capital in connection with patents and participations. The federal government estimates that around a third of the profits of today's special-status companies could fall into the patent-box category. The patent box is unlikely to be of much relevance to less R&D-intensive sectors such as the wholesale trade, even in the case of a broad interpretation.

### Time frame for implementing CTR III



Source: Credit Suisse

\* WAK-S/WAK-N: Committee for Economic Affairs and Taxation of Council of States and National Council respectively

**Further tax policy measures**

Finally, the rules for the disclosure of hidden reserves are set to change. Companies form these reserves by undervaluing assets or overvaluing liabilities. In the event of these reserves being released, e.g. the sale of assets, the respective profits are subject to tax. Under the CTR III, existing reserves are to be taxed at a lower rate to ensure uniform treatment. In addition, companies relocating to Switzerland will have to disclose their hidden reserves. These are not taxed and may be written off over several years («step-up»). The internationally widespread tonnage tax – a flat-rate tax for shipping companies based on freight capacity – was rejected.

**Financial policy measures**

Under the CTR III, today's special-status companies will be subject to standard cantonal income tax rates – unless their income is covered by the new privileges. In recent years the federal government has benefited disproportionately from the setting up of special-status companies. More than half the tax receipts flowed into federal government coffers. The federal government is aiming to thwart a potential exodus by companies that currently enjoy special status. It therefore intends to give the cantons additional scope to reduce standard profit tax rates via an increase in the cantonal share of direct federal taxes. The cantons currently keep 17% of these receipts. This share is to increase to 20.5%, signifying an annual decrease in receipts of around CHF 1 billion for the federal government. During the consultation, some cantons were calling for a further increase in the cantonal share. The Council of States is proposing a figure of 21.2%.

**Adjusting the fiscal equalization system**

Finally, the intercantonal fiscal equalization (NFE) system is to be adjusted given that profits currently taxed on a privileged basis would otherwise flow into into the resource potential with too great a weight. The NFE measures the economic performance of the cantons. The consequence would be changes to the equalization payments between the cantons – even though economic circumstances remain unchanged (see p. 23 onward).

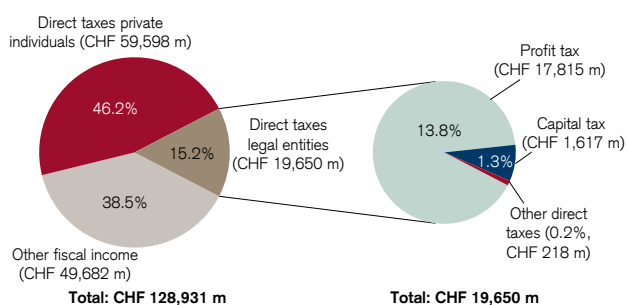
**A reform with major impact – especially for cantons Vaud and Geneva**

The CTR III is of great importance to Switzerland as a business location: companies make a major contribution to government finances at 15% of the total tax take (see chart). Profit taxes represent more than 90% of this and capital taxes – which are levied at cantonal and municipal levels only – around 8%. Abandoning cantonal tax privileges without a replacement would probably result in an exodus of special-status companies, which are of considerable importance to Switzerland (see chart). They generate around half the profit taxes of the federal government and one fifth of the profit taxes of cantons and municipalities – in Geneva and Vaud the figure exceeds 30%. Added to that, these businesses are often among the most innovative in their sector and employ a total of approximately 150,000 people (3.2% of employment). In the canton of Geneva there were around 1,100 special-status companies (3% of all businesses) in 2011. They employ 22,000 people directly (8% of employment), around half of whom work in the head offices of multinational firms, 4,000 in the chemicals industry, 4,000 in commodity trading, and nearly 2,000 in domiciliary companies. For Vaud the figures are 218 special-status companies and over 9,000 jobs (3% of employment). These numbers do not include holding companies.

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**Businesses generate over 15% of total tax receipts**

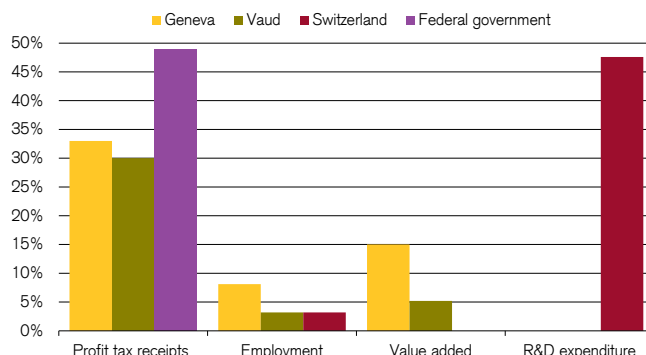
Total fiscal receipts at federal, cantonal and municipal level, 2013, by income group



Source: Federal Department of Finance, Credit Suisse

**Special-status companies very important to economy**

Share of profit tax receipts, employment, value added and R&D spending generated by special-status companies



Source: Federal government, cantons, Créa, Credit Suisse



## Cantonal Tax Competition

# Profit Taxes – Reshuffling the Cards

The Corporate Tax Reform III will intensify tax competition. The cantons of Geneva and Vaud are under particular pressure due to the importance of special-status companies and high standard rates of profit tax.

**Maintaining competitiveness by lowering the standard rate of profit tax**

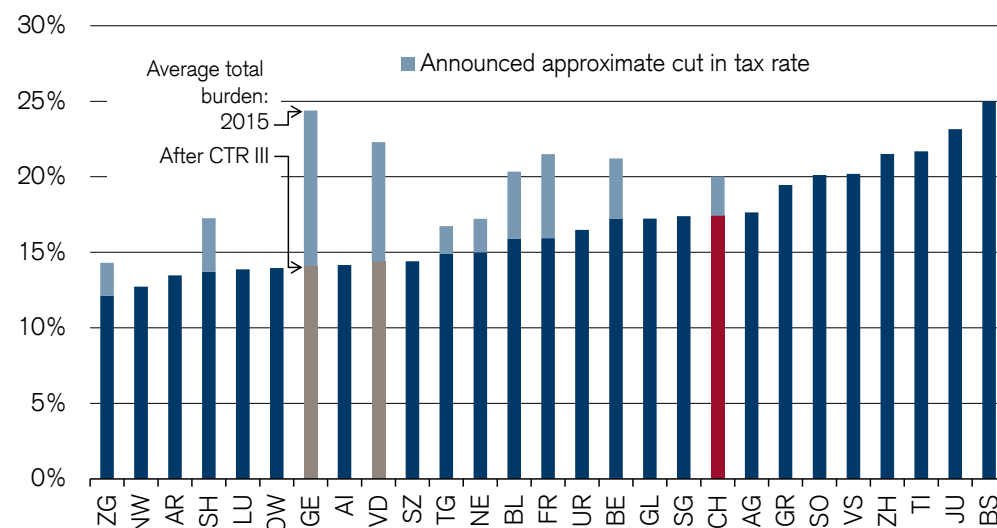
Many businesses will likely be unable to benefit from the planned new tax instruments (in particular the patent box and R&D assistance). Therefore, the cantons will increasingly have to attract business based on their standard rates of income tax. A number of cantons propose lowering their standard rate of profit tax, in some cases considerably (see chart). A majority of cantons (including Basel-Stadt and Valais) intend to make reductions, though many have still not announced any specific figures. The reform proposal is currently the subject of parliamentary deliberation. Cantonal tax strategies also depend on the measures taken by the other cantons as well as rival international locations. We are thus likely to see a further shift in the positions taken by the cantons. In addition, in most cantons the tax cuts need to be approved by voters. Tax competition is likely to pick up again, however.

**Geneva and Vaud move well up the rankings list**

The chart below shows the overall burden (federal government and cantons) due to profit and capital taxes in 2015 and following implementation of the announced cuts in profit tax. The canton of Vaud is proposing a reduction in the rate of profit tax to 13.79% (including direct federal tax). The canton of Geneva is aiming towards a rate of 13%. This would propel Vaud and Geneva into the top third of all cantons. The other French-speaking cantons will likewise become significantly more attractive. In this hypothetical reorganization, the low-tax cantons in central and eastern Switzerland will remain at the top of the table, although their lead over the other cantons will narrow. Because the federal tax rate – which applies to all cantons – will remain unchanged at just under 8% while cantonal tax rates fall on average, the portion of corporate taxes independently levied by the cantons will decline. The CTR III is therefore a step toward a material harmonization of taxes.

### Geneva and Vaud planning sharpest cut in standard profit tax rates

Overall burden\* of taxes on profit and capital (federal, cantonal, municipal), as % of net profit, 2015, and taking into account the lowering of profit tax rates already announced by the cantonal governments



Source: TaxWare, cantons, Credit Suisse

\* Average burden before taxes for a company with capital of CHF 2 million and net profit of CHF 80,000 –1,040,000

**Major knock-on effects for cantons with few special-status companies and high rate of profit tax**

The sovereignty of the cantons allows them to set their own tax policy strategy depending on the importance of special-status companies, the relevance of corporate taxation to their locational appeal, the intensity of intercantonal and international tax competition as well as the financial scope. Cantons with a high standard rate of profit tax, where special-status companies account for a major portion of taxable profits and whose income is not covered by one of the new tax policy measures (e.g. patent box), are under particular pressure. Without a clear reduction in the standard rate of profit tax, there is a risk that mobile companies will relocate to lower-tax cantons or abroad. At the same time, it is easier for cantons such as these to reduce their standard rates without risking a significant reduction in receipts.

**Geneva proposing big tax cut for companies charged at standard rate**

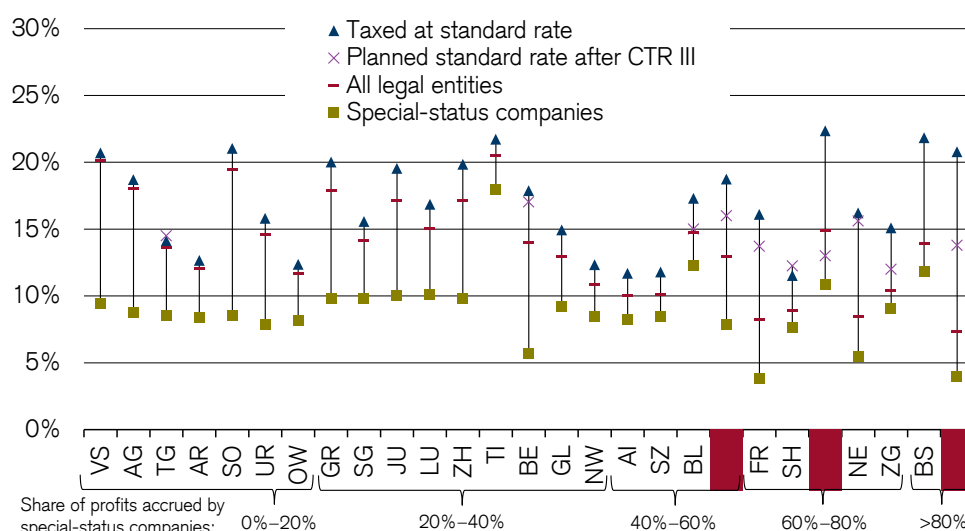
The canton of Geneva taxed corporate profits at an effective standard tax rate averaging around 22% (federal, cantonal and municipal) in 2009–2011 – one of the highest standard rates in the country (see chart). However, an above-average number of companies that benefit from preferential taxation have settled in both Geneva and Vaud. In Geneva's case, the profits of special-status companies account for about 70% of all profits and were taxed at around 11% on average. This means they contributed over 30% of the canton's profit tax receipts (see chart on p.11). The average effective profit tax rate across all firms was around 15% – well below the standard rate. The planned reduction in the standard tax rate to approximately 13% results in a slightly higher tax charge for those special-status companies unable to benefit from the patent box, whereas all firms subject to the standard tax rate will enjoy significant relief (knock-on effect).

**Without the patent box, tax-privileged companies in Vaud face a considerable tax hike**

The canton of Vaud has a similarly high standard tax rate to Geneva, but charges special-status companies less than 4% – with only the canton of Fribourg undercutting this rate.<sup>1</sup> The standard 13.79% rate proposed by the cantonal government represents a considerable tax hike for companies currently enjoying privileged tax rates. Unless they can benefit from tax reductions (e.g. patent box), some of these companies are likely to migrate to lower-tax locations. On the other hand, companies that are taxed at the standard rate – and currently account for nearly 20% of the profit tax base – will benefit from a significant tax cut.

**Major gap between standard and privileged tax rates**

Effective profit tax rates for companies taxed at standard and privileged rates, as well as average for all businesses, 2009-2011, planned standard rate under CTR III according to cantonal authorities



Source: Swiss Federal Tax Administration, cantons, Credit Suisse

<sup>1</sup> In the case of some cantons the tax charge is below the standard rate of federal tax. This is due to tax breaks under the New Regional Policy (formerly the «Lex Bonny»). In the case of newly established businesses that further the economic interests of the canton, a canton is permitted to grant tax breaks for up to 10 years. Additionally, the federal government can help businesses to settle in structurally weak regions through reduced direct federal tax. In some circumstances, therefore, a special-status company will not be required to pay any cantonal profit tax and will only pay a reduced direct federal tax. This instrument is currently being revised.

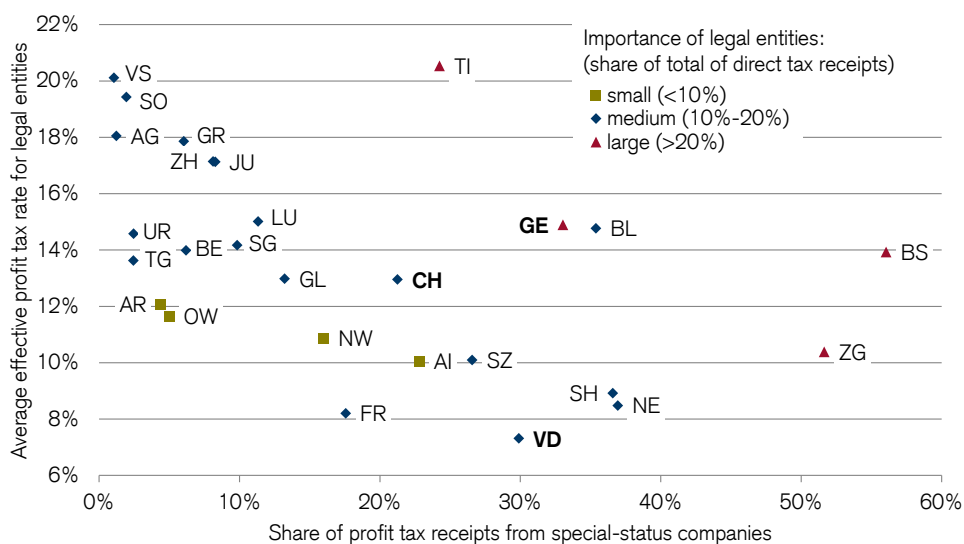
**Intercantonal tax competition also pressuring cantons with few special-status companies**

For cantons like Valais, Aargau and Solothurn, where special-status companies play only a minor role, an exodus of these companies presents little risk. Nevertheless, these cantons need to review their corporate taxes given that intercantonal tax competition is likely to intensify due to the reductions made by other cantons. These cantons are in a difficult position, since a similar reduction in the standard tax rate causes a significantly greater receipts shortfall in the case of standard-rate tax payers. The preservation of tax competitiveness – for both special-status companies and normal companies based there – is a more costly affair in such cantons. Those cantons particularly affected include Solothurn, Zurich and Ticino, where company taxes account for an above-average share of direct tax income at 19% to 25% (see chart). The canton of Bern, on the other hand, generates a significantly higher portion of direct taxes from individuals (only 11% comes from businesses). Although the cantons of Bern and Zurich currently have a similar standard rate of profit tax, Bern loses less income when an attractive rate of profit tax is set.

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**Geneva and Vaud had put their faith in privileged taxation**

Importance of special-status companies in terms of their share of profit tax receipts (x-axis), effective profit tax rate (y-axis) and share of direct taxes from businesses (colored symbols), 2009-2011



Source: Swiss Federal Tax Administration, Credit Suisse

## Economy of the Lake Geneva Region

### Limited applicability of patent box in Lake Geneva region

The canton of Geneva sees opportunities for the privileged taxation of patent income, above all in chemical sectors. Only in the case of a broader-based definition could certain corporate headquarters, luxury goods producers and trading firms also benefit. In terms of patent filings, the cantons of Vaud and Geneva lie in the upper mid-range. Bio/medical technology and the pharmaceutical industry are among the innovative sectors there, with a total of 30% and 16% of all patents respectively. The patent box is likely to be applicable here. Information and communications technology account for 23% and 43% of all patents respectively.

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### Numerous start-ups in Geneva and Nyon

The start-up rate in the Geneva-Montreux metropolitan region is above the Swiss average. In the canton of Geneva and above all Vaud, however, start-up rates have been on the decline since 2010. Between 2011 and 2013, new firms in Vaud and Geneva created around 1,600 jobs annually. The most dynamic sectors included construction (12% of all new jobs), activities related to financial and insurance services (8%), the wholesale trade (7%) and corporate administration/consulting (7%). Measured in terms of employment, the contribution tends to be fairly minimal given that firms generally start off small.

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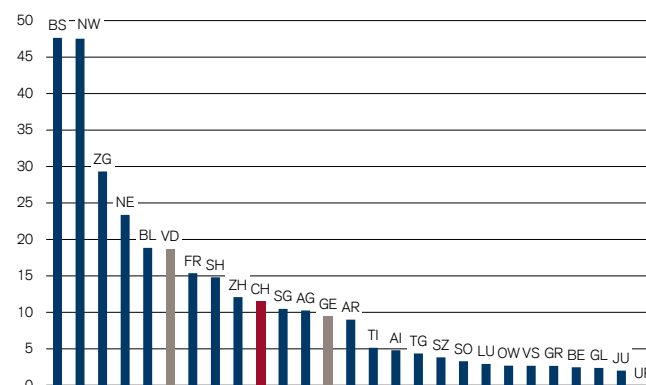
### Broad-based economy in Vaud and Geneva

Studies by the University of Lausanne show that those companies in Geneva and Vaud affected by the CTR III are almost exclusively based in the service sector. The trading, financial and insurance services sectors, along with corporate administration and consulting, are said to be particularly affected. The sector structure in the Lake Geneva region is broadly diversified. Major sector focal points are among the sectors potentially affected by the CTR III. Corporate consulting and head offices play an above-average role in Vaud, and the wholesale trade and banks in Geneva.

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### Patent filings

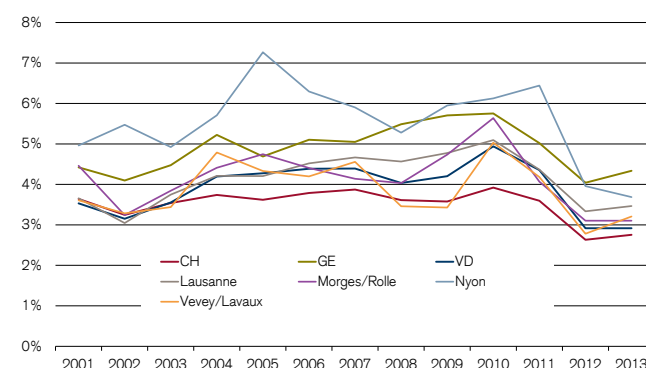
Per 10,000 employees, by applicant's domicile, 2012



Source: OECD, Swiss Federal Statistical Office, Credit Suisse

### Start-up rates

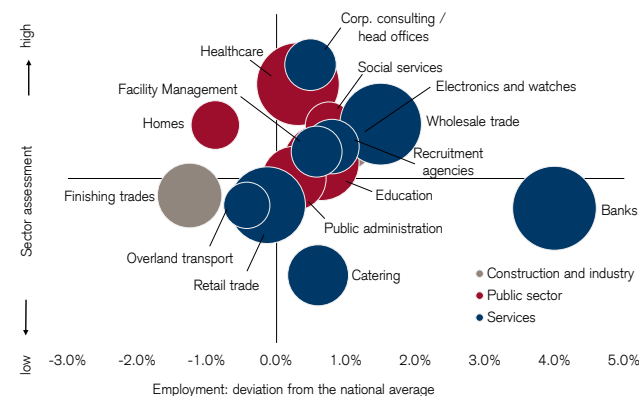
Proportion of newly established businesses as % of total businesses



Source: Swiss Federal Statistical Office, Credit Suisse

### Sectoral structure

Cantons of Geneva and Vaud, opportunity-risk profile of 15 largest sectors, 2015, size of circle: employment



Source: Swiss Federal Statistical Office, Credit Suisse

# Locational Quality | International

## Cost Benefits Thanks to Low Interest Rates and Taxes

Swiss business locations are attractive but expensive by international standards. Companies compensate for this cost disadvantage by innovating and specializing. However, price advantages do exist in terms of interest rates and corporate taxation.

### Locational quality as basis for prosperity

The long-term development of a region's ability to create value and prosperity is determined by the economic framework conditions. New firms tend to base themselves at attractive locations, while companies already located there invest more heavily than in less attractive areas. Key criteria determining the quality of a location include not only immutable natural factors but also government regulation, the availability of labor, as well as the business environment.

### Switzerland's high level of competitiveness

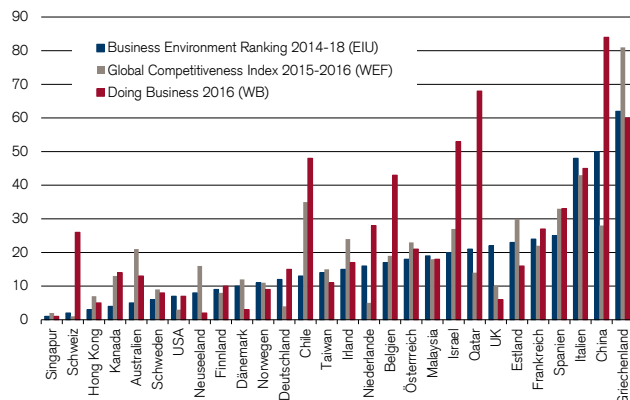
Switzerland is positioned among the most attractive business locations in numerous global ranking lists (see chart). Political stability, high-quality infrastructure and educational institutions, industrial harmony and healthy public finances are among the country's most important strengths. In the case of Geneva and Vaud, the considerably higher level of attractiveness compared with France is particularly important. The studies describe the growing trend toward isolationism, restrictions on international market access and an aging population as threats to Switzerland's competitiveness.

### Attractive for trading and corporate headquarters

Comparatively high labor and land costs, which have risen further following the sharp rise in the value of the Swiss franc, constitute clouds on the horizon and are presumably an obstacle to attracting businesses. Businesses with high labor and land requirements can only hold their own in Switzerland if they are able to offset the cost disadvantages through innovation and specialization. All the same, Switzerland exhibits two notable advantages in cost terms: the cost of capital, i.e. level of interest rates, and the tax burden are significantly lower than in neighboring European countries. Capital-intensive (e.g. wholesale trade, financial services) and tax-sensitive activities (e.g. corporate headquarters) benefit not only from the high level of locational quality in Switzerland but also from cost advantages.

### High locational quality for companies by international standards

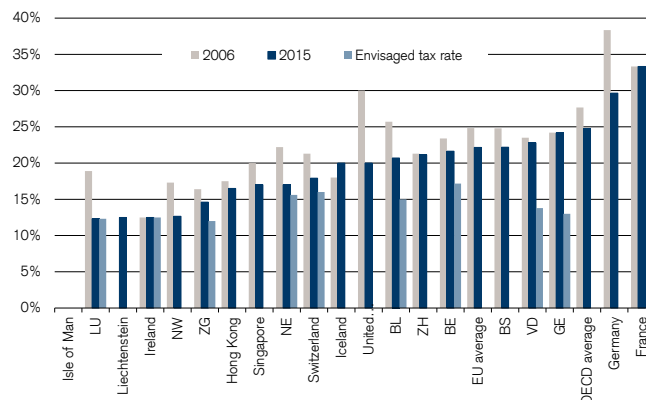
Rankings list for framework economic conditions according to EIU, WEF and World Bank, by EIU ranking



Source: Economist Intelligence Unit, World Economic Forum, World Bank, Credit Suisse

### Geneva and Vaud – currently slightly below OECD average in terms of corporate taxes

Maximum profit tax rates, CH: main cantonal city, envisaged profit tax rate under CTR III



Source: KPMG, government sources, Credit Suisse

**Two strategies for success**

In view of Switzerland's framework conditions and the available expertise, internationally oriented Swiss companies opt for either premium or cost strategies:

- **Premium strategies** require outstanding products or services in terms of quality, innovation or technological intensity. This enables higher costs and prices to be justified. Examples include luxury products and pharmaceuticals as well as complex medical treatments.
- **Cost strategies** are possible if high (wage) costs can be offset by savings on taxes or the cost of capital. One option for the workplace is the radical automation of production processes.

**Standard tax rates becoming more important**

From a tax perspective, Switzerland has been among the world's most attractive business locations for decades. This is firstly down to its comparatively low standard rates of profit tax (see chart). Second, Swiss tax legislation grants privileges to internationally oriented companies. In 1903, Glarus became the first canton to allow holding companies to pay lower tax rates on their international income. This model was gradually extended to other types of company. In this way, Switzerland was able to attract mobile, tax-sensitive companies. With the abandonment of privileges for special-status companies, the focus will shift to standard tax rates. The tax breaks granted under the New Regional Policy (formerly the «Lex Bonny») are also important for international tax competition: companies that set up in structurally weak parts of the country can benefit from tax breaks at cantonal and federal level.

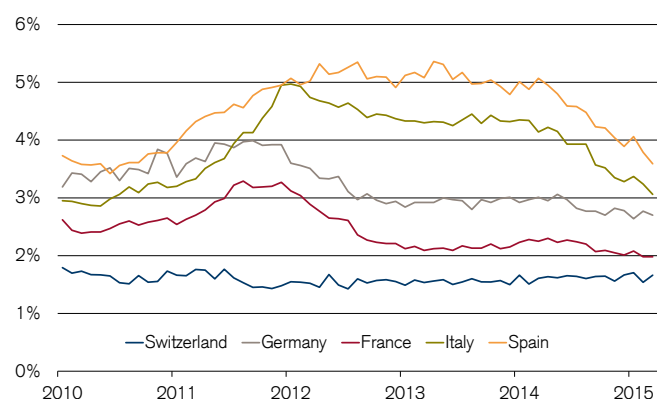
**Uncertainty is toxic for investment**

The attractive framework conditions have prompted numerous foreign companies to locate their head office or other parts of their business in Switzerland. The number of firms attracted has fallen sharply since 2010, however. This is to some extent explained by the fact that the exchange-rate situation has made it more expensive to set up business in Switzerland. Another reason is the uncertainty that has arisen following referendums (e.g. on minimum wage and mass immigration) as well as the unclear future for taxation. The comparatively high level of political stability was and still is a crucial factor for Switzerland's success relative to rival locations. In this respect the increasing clarity regarding the implementation of the Mass Immigration Initiative and the Corporate Tax Reform III is of vital importance to Switzerland's appeal as a business location.

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**Switzerland – a country of low interest rates**

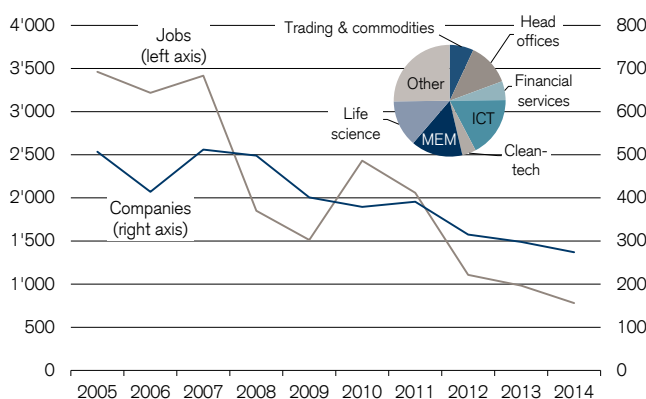
Interest rates for loans up to 1 year and EUR 1 m, Switzerland: up to 6 months



Source: Datastream, SNB

**Fall in number of businesses attracted**

Number of jobs and companies, sectors: number of companies 2014



Source: VDK

## Locational Quality | Switzerland

# Lower Taxes Improve Locational Quality

With the planned reductions in profit tax rates, the Lake Geneva region will also become attractive for companies taxed at the standard rate. Nyon and Geneva will offer a particularly attractive overall package.

### Credit Suisse Locational Quality Indicator

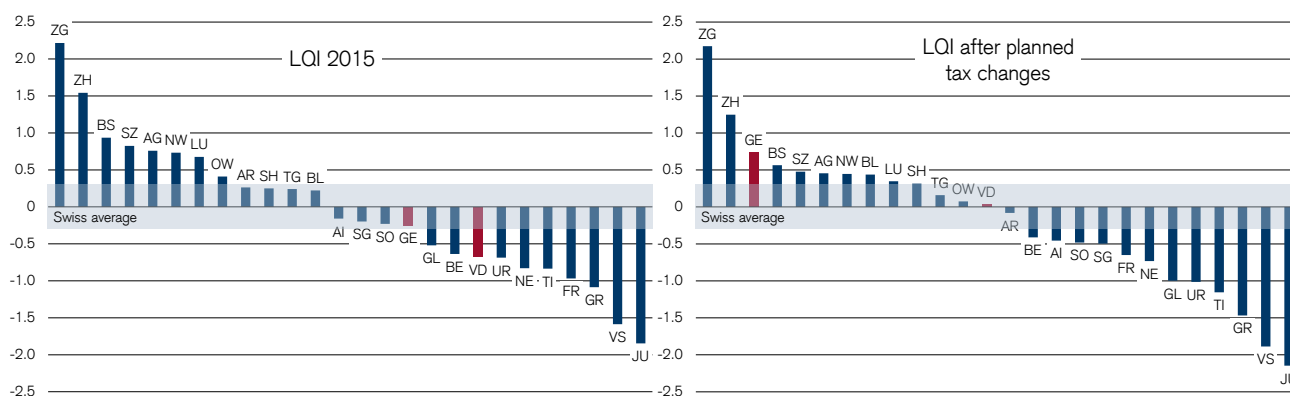
Our Locational Quality Indicator (LQI) was developed in order to measure the attractiveness of Switzerland's regions and cantons from a business point of view.<sup>2</sup> The LQI is based on the following seven quantitative sub-indicators and depicts the attractiveness of an area in the form of a relative index: tax burden on individuals and companies, availability of highly qualified and specialist employees, as well as the accessibility of the population, the workforce and airports. Land prices and wage costs are deliberately omitted, as to some extent they are merely a reflection of the degree of attractiveness.

### High standard taxes reduce locational quality of French-speaking Switzerland

The good availability of highly qualified employees and proximity to Geneva Airport contribute to its appeal to companies. In terms of the other aspects of locational quality, however, the cantons of Geneva and Vaud do not rank among the frontrunners. This is mainly down to the tax burden: standard tax rates for individuals, but particularly for businesses, are higher than in most economic centers in German-speaking Switzerland. The above-average spread of special-status companies taxed at privileged rates may result in a lower average tax burden for the respective companies. However, these taxation privileges depend on each company's specific earnings structure and are only statistically measurable to a limited extent due to tax confidentiality. Companies subject to standard tax rates face comparatively high taxation. For private individuals specific tax privileges play a role as well: the cantons of Vaud, Valais, Ticino and Geneva account for 77% of the lump-sum tax deals reached with private individuals. The LQI is therefore exclusively calculated using standard tax rates.

## Locational quality of Swiss cantons in 2015 and following planned tax changes due to CTR III

Locational Quality Indicator (LQI), synthetic index, Switzerland = 0, 2015 and following recalculation of the sub-indicator for the tax burden on individuals



Source: Credit Suisse

<sup>2</sup> Further information: «Locational Quality of the Swiss Cantons and Regions: A Guide for Business and Policy-Makers», Credit Suisse, September 2013.

**Tax competition on basis of standard tax rates**

The likely abolition of the privileged taxation of special-status companies signifies a change of system that is also likely to result in greater transparency in terms of the effective tax burden. Locational competition to attract companies will increasingly be based on standard rates of profit tax. At the same time, this results in a more precise depiction of the average tax burden in the LQI. A shift in positions is also likely given that various cantons including Geneva and Vaud wish to reduce their standard profit taxes substantially. In contrast with the factors that can be influenced in the longer term (availability of specialist and highly qualified employees, accessibility of population, workforce and airports), the tax burden is the easiest one to change.

**Cut in profit taxes: hypothetical reordering of cantonal rankings**

Based on the changes already announced (see p. 9) with regard to profit tax, we have recalculated the LQI sub-indicator of tax attractiveness to legal entities. Publicly available information from the cantonal governments was taken into account for this hypothetical reordering of the cantonal rankings. A survey of the cantonal tax authorities carried out for this study also showed that various cantons are examining changes to their profit tax rates but have not yet made any concrete announcements. The newly calculated cantonal rankings are intended – based on what we currently know – to provide an insight into the direction in which locational quality might develop.

**Geneva would now be third in cantonal rankings**

Following the reduction in the rate of profit tax to around 13%, the canton of Geneva would now be in third place – an improvement of 13 places. At a stroke, it has therefore moved into the top third in terms of intercantonal tax competition – even for companies taxed at the standard rate. Together with the locational factors mentioned, this results in an even more attractive environment for companies.

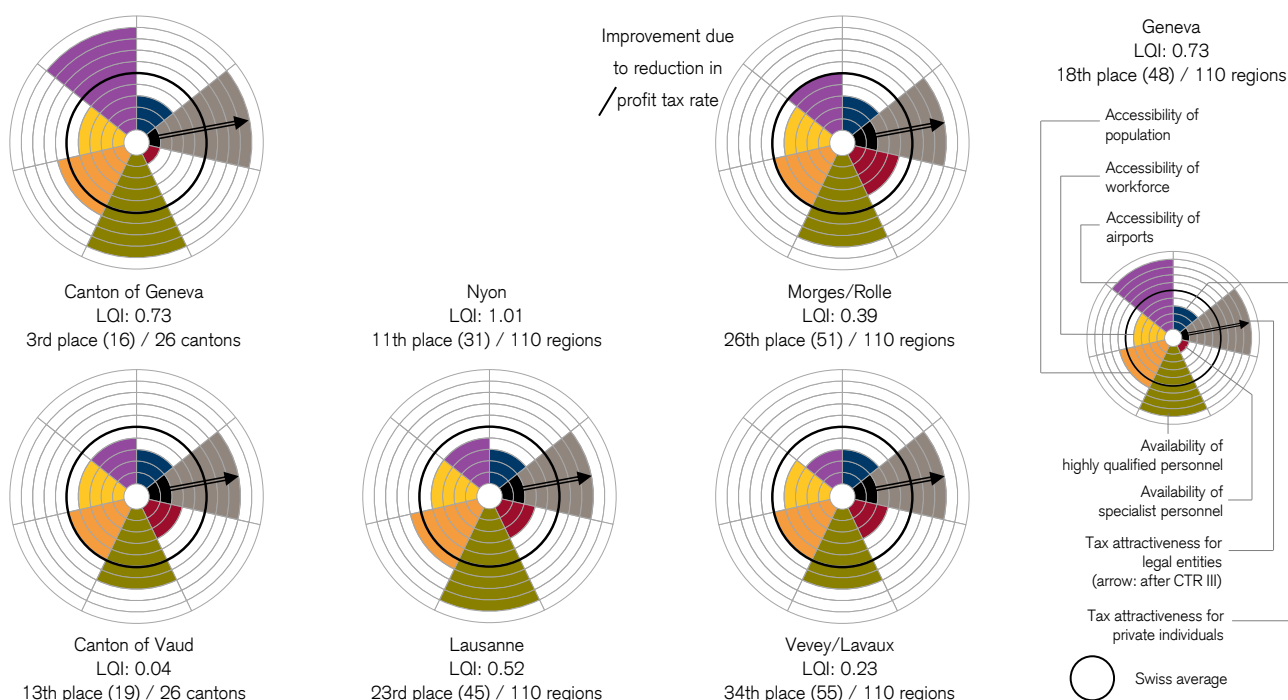
**Vaud would now be just above the national average**

The canton of Vaud could also advance by six positions to 13th place following a reduction in the rate of profit tax to 13.8% – more or less in line with the Swiss average. It misses out on a better placing due to its poorer airport accessibility, high tax burden on private individuals and below-average figures for workforce accessibility and the availability of specialist personnel. The new tax attractiveness results in improvements in the overall ranking in the four regions of the canton that were examined. Nyon, for example, climbs 20 places to 11th position. The other regions would also move into the top third, even though the regional disparities remain considerable.

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**Factors of locational quality: falling tax burden increases attractiveness**

Synthetic indicators, recalculation of sub-indicator for tax burden on legal entities, rank according to LQI 2015 in brackets



Source: Credit Suisse



## Economy of the Lake Geneva Region

### High added value on Lake Geneva's right bank

Gross domestic product (GDP) per employee enables a comparison of the economic strength of the regions and assessment of the respective sector portfolio. Figures for the period up to 2013 are available at cantonal level. The canton of Zug tops the ranking. Geneva achieves a productivity of just under CHF 173,000 per employee thanks to high-value-added activities in the service sector. The canton reaches a value creation considerably higher than the Swiss average of CHF 163,000. The canton of Vaud, on the other hand, reaches with CHF 150,000 only below-average productivity.

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### Medium-sized and large firms: important employers

Small and medium-sized enterprises (SMEs) typify Switzerland's economic structure. However, medium-sized and large companies play an important role in the cantons of Vaud and especially Geneva. Over 40% of all employees in Vaud and more than 50% in Geneva work in companies with more than 50 employees. Indeed at 23% Geneva shows the second highest proportion of large companies after Basel-Stadt. Vaud follows in fifth place with 18%.

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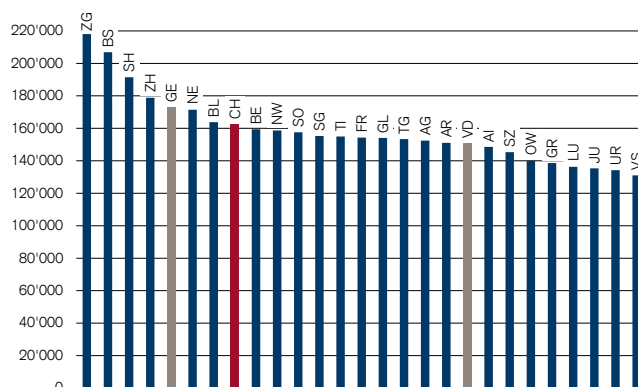
### Sharp increase in employment in Nyon and Lausanne

Employment in the Lake Geneva region has significantly outperformed the national average since 2004. Even the financial crisis posed significantly less of a problem for the region. Between 2011 and 2013, jobs were created in Nyon and Lausanne in particular – led by business services, construction and in Nyon's case high-tech industry too. Growth in employment in Vevey/Lavaux and Morges/Rolle was limited, however. In Geneva, jobs were created above all in administrative and social services, construction, trading and transport. Financial and business service providers shed jobs, on the other hand.

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### Productivity

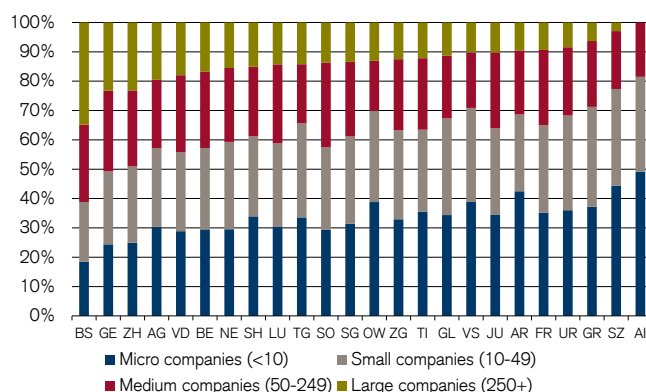
Gross domestic product per employee (full-time equivalents) in CHF, 2013



Source: Swiss Federal Statistical Office, Credit Suisse

### Economic structure

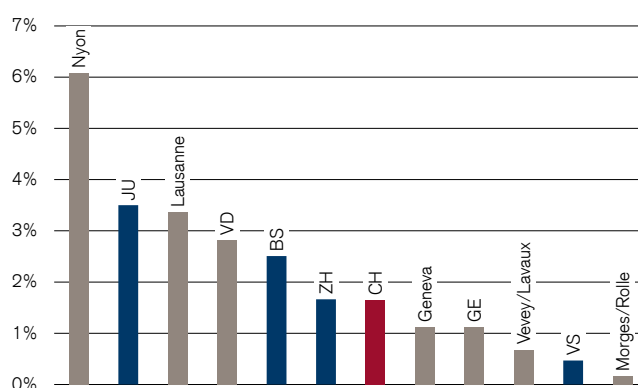
Share of employment by size category, full-time equivalents, 2013



Source: Swiss Federal Statistical Office, Credit Suisse

### Employment

Employment growth 2011–2013 (full-time equivalents), in %



Source: Swiss Federal Statistical Office, Credit Suisse

## Office Markets

# Impact on Office Market Is Moderate

**Geneva and Vaud have excess supply of office space. Demand has been dampened by waning economic momentum, the decline in the number of business being attracted from abroad and uncertainty with regard to the CTR III. The announced cuts in profit tax and rapid implementation of the CTR III are likely to calm matters.**

### Surplus capacity in the office property market

In contrast with the shortage of housing, the office property market in the main centers shows excess capacity. In the Geneva office market, the supply rate in the third quarter of 2015 was a high 7.8% of the total stock (see chart). After persisting at a relatively low level for years, the volume of advertised floor space almost doubled between 2011 and 2014. Last year saw a reduction in the volume of advertised space. The canton of Vaud also experienced a sharp increase in advertised office space, bringing the supply rate up to around 5.7%. At 8.6% and 11.6% in Nyon and Morges/Rolle respectively, advertised office space stock is considerably higher than in Lausanne – the canton's most important market for office space.

### Locational uncertainties limit demand for traditional office properties

Traditionally designed office properties for corporate headquarters, banks, insurers and business service providers have suffered from an unfavorable combination of negative factors for a number of years. International pressure on banking confidentiality and the tax privileges Switzerland grants international groups has not only triggered far-reaching structural change in the banking sector but is also causing uncertainty for international holding companies. The demand for office space in Geneva has therefore slumped. This has also been fueled by the strength of the Swiss franc, the shortage of housing and the additional uncertainty due to referendums. For Vaud and Geneva the Corporate Tax Reform III should be taken seriously as a demand-limiting factor, particularly given that standard rates of profit tax are not especially attractive even by international standards. The cuts in tax rates proposed by both cantonal governments are an important signal to the multinational companies based there that tax competitiveness is to be preserved.

### Market being stabilized by minimal expansion of supply

The high rate of construction activity seen in Geneva in recent years is only now being fully reflected in vacancy rates, which have tripled in the space of a year. Vacant properties in the canton of Vaud have stabilized (see chart). Dwindling demand since 2011 and the rise in vacant office properties have depressed interest among investors. This is reflected in a decline in building permits (see chart). Right now the volume of approved office property in Lausanne in the last 12 months is well below the long-term average volume of investment at CHF 23 million. After several years of falling investment, Geneva has seen a renewed rise to CHF 157 million; however, this is largely due to a major project close to Geneva Airport.

### Office property market in detail

Total stock and available space (existing and new construction) in m<sup>2</sup>, as at third quarter 2015; average prices (net) 2015, weighted by space in CHF/m<sup>2</sup>

Economic region	Existing stock of office space	Available space	Supply rate	Average rent
Geneva	4,223,550	327,460	7.8%	443
Lausanne	2,388,717	138,522	5.8%	297
Nyon	373,053	32,242	8.6%	264
Morges/Rolle	358,499	41,560	11.6%	235
Vevey/Lavaux	397,729	8,117	2.0%	288
Zurich	6,990,264	426,147	6.1%	345
Bern	3,533,772	76,383	2.2%	266
Basel	2,252,789	82,306	3.7%	230
Switzerland	52,365,502	1,946,345	3.7%	298

Source: Meta-Sys AG, Credit Suisse

**Impact of CTR III on office market difficult to gauge**

The impact of the Corporate Tax Reform III on the office market in the Lake Geneva region is difficult to gauge. A number of issues remain outstanding and will likely only be clarified in the course of the parliamentary deliberations. In addition, the Swiss solution also depends on international developments. The intended changes in corporate taxation are not only designed to reduce an exodus by special-status companies currently taxed at preferential rates but also to improve the position in terms of intercantonal tax competition. The cantonal tax changes will need to be put to a referendum, at least in the canton of Vaud. In addition, special-status companies face considerable tax increases, even in the event of the implementation of the planned cuts in profit tax – unless they can take advantage of tax reductions in future too. Added to that, international moves toward a situation where tax is levied at the place where economic activities are performed and value is created are likely to result in the relocation of some companies.

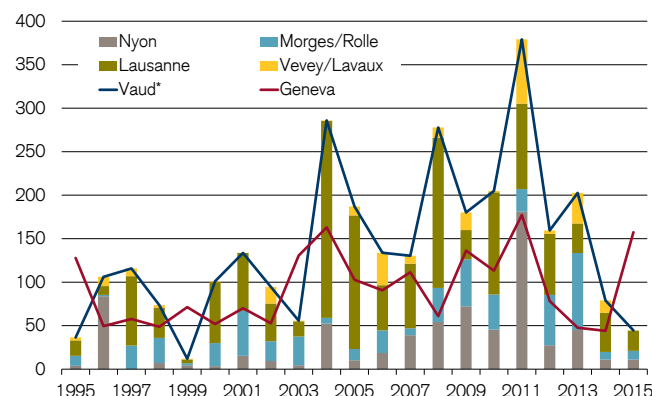
**Special-status companies occupy manageable share of office properties**

According to estimates by the University of Lausanne, around 22,000 jobs (8.1% of employment) in the canton of Geneva will be directly affected by the CTR III. The figure for the canton of Vaud is approximately 9,200 full-time jobs (3.2%). Assuming an average space requirement including access area of 20 m<sup>2</sup> per employee, these companies occupy total office space in the region of 440,000 m<sup>2</sup> in Geneva and 184,000 m<sup>2</sup> in Vaud. This represents approximately 10% respectively 4% of the office stock. The extent of any exodus by special-status companies and the indirect impact on other companies in the region are virtually impossible to predict. The Lake Geneva region remains internationally attractive in tax terms and could therefore also see companies relocating from other Swiss cantons as well as from abroad. But given limited demand for office space among current special-status companies, the indirect effects of an exodus of companies on the office market is likely to be modest anyway. Assuming that in Geneva around 10% of the jobs affected by the CTR III disappear and are not replaced, 44,000 m<sup>2</sup> would be added to the office space currently available (approx. six football fields). This would represent a 13% increase in the available stock. In Vaud, supply would expand by 8% (18,400 m<sup>2</sup>) in the above scenario. However, the bottom line is that the current weak demand for office space is likely to continue in the medium term.

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**Building permits at low level**

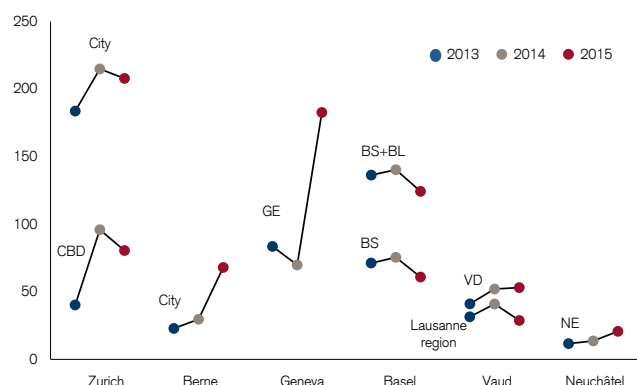
Approved office construction volume in Lake Geneva region, 1995–2015, in CHF m



Source: Baublatt, Credit Suisse \* Regions of Nyon, Morges/Rolle, Lausanne and Vevey/Lavaux

**Development of vacancy rates**

Vacant office space as at June 1, in '000 m<sup>2</sup>



Source: Various statistical offices, Credit Suisse

## Impact of CTR III | Cantonal Finances

# The Price of Attractiveness

The cantons of Vaud and Geneva raise a third of their profit tax receipts from special-status companies. In the short term the proposed tax reductions are likely to hit Geneva's finances to a significantly greater extent.

### The end of surpluses

The cantons of Vaud and Geneva have continually posted surpluses in recent years. For Geneva at least, this series of surpluses is likely to end with the 2015 accounts: in place of a budgeted surplus of CHF 14 million, the canton expects a deficit of up to CHF 200 million – despite a doubling of the profit distribution from the Swiss National Bank (CHF 77 million). But even in the financially very solid canton of Vaud, the era of major surpluses seems to be over.

### Cantons expecting high costs

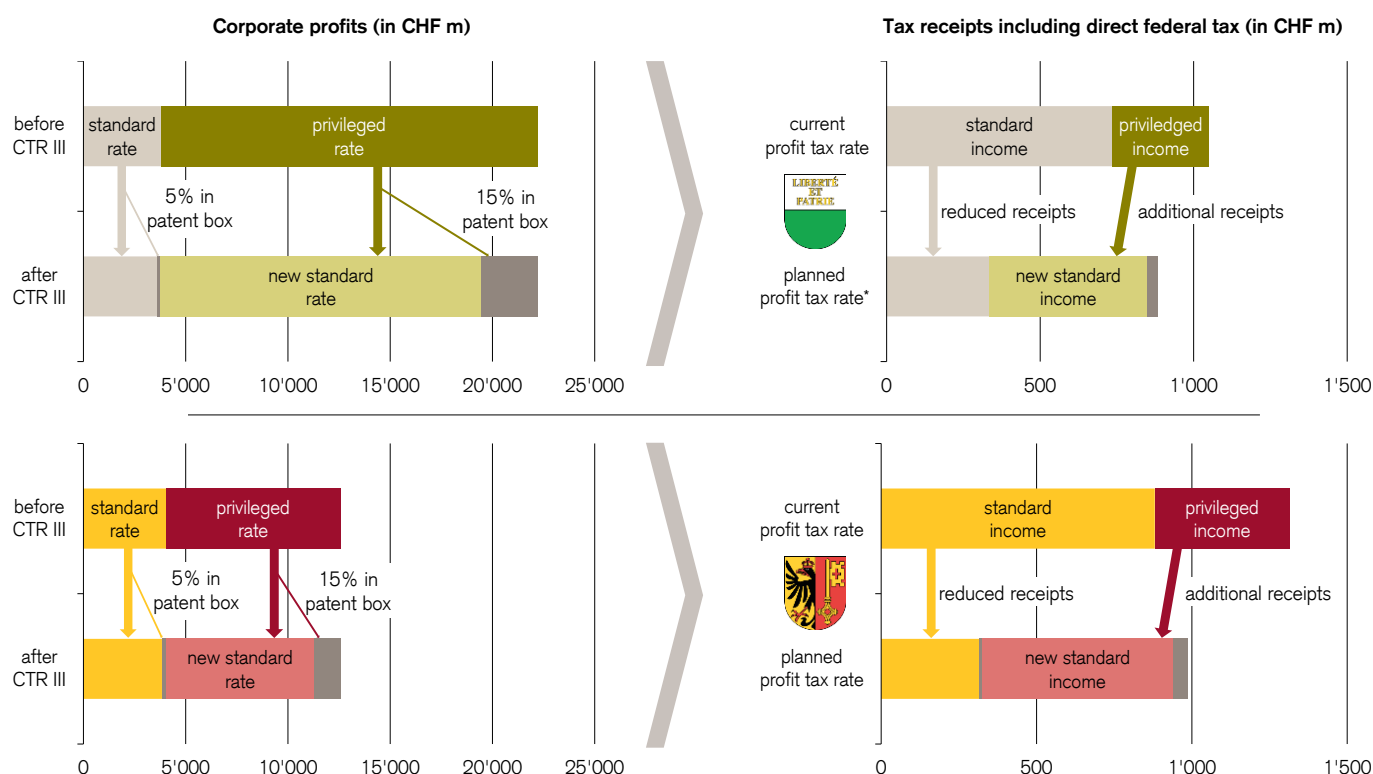
Another financial hazard appears to be looming with the CTR III: Vaud and Geneva each expect a direct annual income shortfall of CHF 400-500 million. By way of comparison, the canton of Geneva and its municipalities generate around CHF 1,300 million in profit taxes each year and the canton of Vaud and its municipalities CHF 1,000 million. Based on our forecasts the shortfall in revenues would be substantial for both cantons.

### Geneva and Vaud in dilemma over tax rates

At first glance, the current situation appears similar in both cantons: at present, they generate around a third of their profit tax receipts from companies taxed at a privileged rate. Both also show comparatively high standard tax rates and therefore face a dilemma: if they leave standard rates at the current level, there is a risk of an exodus by companies that were previously taxed at a favorable rate to other countries or other cantons that are more attractive in tax terms. If, on the other hand, they reduce their standard profit tax rates in order to remain attractive to these mobile companies, a portion of the income of the companies previously taxed at the standard rate is lost as they too enjoy a lower uniform tax rate (knock-on effect).

### Tax reduction likely to hit Geneva's finances harder than those of Vaud

Average profits and tax receipts of the cantons and their municipalities (2009-2011 assessment basis), static view before and after CTR III



Source: Federal Tax Administration, cantons, Credit Suisse

\*Assumes lower effective tax rate due to tax breaks under New Regional Policy (formerly «Lex Bonny»)

### Shortfall in receipts due to knock-on effects

The knock-on effect in Geneva and Vaud is likely to be substantial, according to our static estimates. This is because both cantons intend to reduce their profit tax rates considerably: Geneva from around 24% to 13%, and Vaud from 22% to 13.8% – including direct federal tax. As a result, over half the tax receipts from companies currently taxed at the standard rate will be lost. The decrease is greater in the canton of Geneva, since it aims to jump from a higher tax rate to a lower one than the canton of Vaud but with a comparable standard tax base: the revenue shortfall in Geneva is likely to be around CHF 560 million and in Vaud CHF 400 million (canton including municipalities).

### Additional receipts from special-status companies

The reform has exactly the opposite effect on the profits of special-status companies: as they will also be taxed at the standard rate in future, their tax burden rises as a result of the CTR III. Based on our estimates, receipts from companies that currently enjoy special status are therefore likely to rise by more than CHF 200 million to CHF 510 million in the canton of Vaud and by CHF 180 million to CHF 615 million in the canton of Geneva. In both cantons, these additional receipts do not compensate for the knock-on effects. This consequently resulted in a shortfall in receipts of around CHF 170 million in the case of Vaud and CHF 330 million in the case of Geneva. This assumes a constant level of taxable profits under the CTR III – in other words, no account is taken of a possible exodus or the setting up of new companies. The calculation includes an increase in the cantonal share of direct federal tax from 17% to 20.5%.

### Limited benefits of patent box

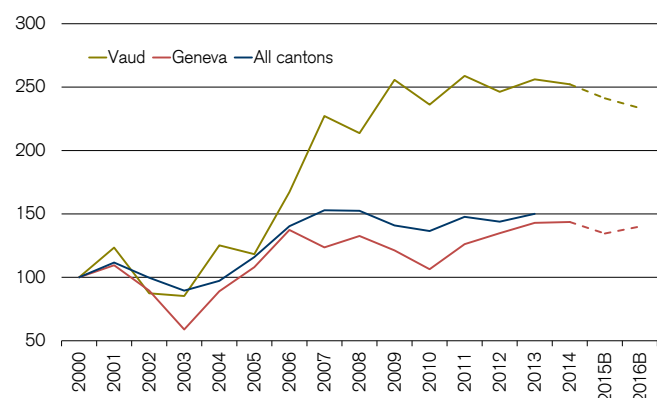
The impact of the tax privileged taxation of royalties and research and development expenses to be introduced with the CTR III is difficult to gauge. Vaud and above all Geneva are likely to derive only limited benefits: a significant portion of the profits taxed at privileged rates in both cantons stems from the trading sector and will tend not to benefit from these measures. We assume that 15% of the profit tax base previously subject to privileged rates – with identical tax privileges – will be included in the patent box. This represents about half the federal government's estimate for average nationwide coverage and comprised receipts of CHF 35 million (Vaud) and CHF 45 million (Geneva). There is also another knock-on effect: around 5% of the profits previously taxed at standard rates are assumed to be taxed at privileged rates in the future.

### Additional tax incentives

The much lower fiscal utilizability of privileged profits in the canton of Vaud is remarkable: in 2009-2011, the holding, domiciliary and mixed companies based there generated total taxable profit of CHF 18.5 billion annually – by far the biggest figure on a Swiss-wide basis. From this sum the canton and municipalities generated around CHF 220 million in tax receipts whereas the federal government generated CHF 540 million. This results in an average tax rate of 4%, due not only to the cantonal privileges but also to additional tax breaks (formerly the «Lex Bonny»).

#### Soaring profit taxes in Vaud

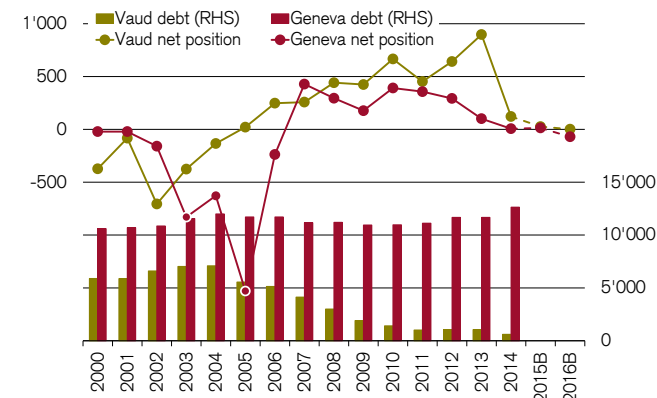
Profit tax receipts, indexed, 100 = 2000; adjusted data (FFA) to 2013, cantonal data from 2014



Source: FFA, cantons, Credit Suisse

#### End of surpluses, high debts in Geneva

Account balances and net debt in CHF million; adjusted data (FFA) to 2013, cantonal data from 2014



Source: FFA, cantons, Credit Suisse

### Delayed effects in canton of Vaud

Assuming constant tax incentives under the New Regional Policy, the cantonal tax rate in Vaud rises only slightly under the CTR III for companies that currently enjoy special status. There are time limits on the tax incentives, however. When these incentives expire, the average cantonal tax burden for affected companies in the canton of Vaud climbs to the standard level of 13.8% – a sharp increase compared with today. From this perspective, the risk of an exodus is significantly higher in the canton of Vaud than in the canton of Geneva – which does not provide any such tax incentives.

### Geneva's finances more heavily affected

The CTR III is likely to amplify the unequal financial performance of the cantons of Geneva and Vaud in the short term. This is indicated by the development of cantonal finances in past years: whereas the debt burden in the canton of Geneva persisted at a high level, the canton of Vaud was able to reduce it sharply. This was also helped by the generally more favorable accounting results in Vaud. In addition, the canton of Vaud has managed to more than double its profit tax receipts since 2000; in Geneva, on the other hand, the growth in revenue was below the Swiss average. The higher level of receipts in the canton of Geneva should be noted, however.

### Advantages beckon in long term

In overall terms, the immediate price of the CTR III is greater for the canton of Geneva than it is for the canton of Vaud. However, Vaud should be worried about a significantly greater exodus on the part of mobile companies once their tax incentives under the New Regional Policy expire: the pendulum could therefore swing in the opposite direction. The cuts in the tax rate are nevertheless likely to prove rewarding for both cantons in the long run. They will strengthen their appeal relative to international rivals as well as other cantons and thus increase their prospects for attracting new firms as well as the opportunities for growth and greater investment on the part of existing companies.

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#### Mixed impact of CTR III on cantonal and federal finances

In 2009-2011, the cantons of Basel-Stadt, Zug, Basel-Land, Neuchâtel and Schaffhausen generated a large portion of their tax receipts from the profits of special-status companies. In Basel-Stadt, however, a significant portion of profits is likely to enjoy tax privileges in future too on account of the weight of its chemical/pharmaceutical sectors (patent box). In addition, the shortfall in receipts (knock-on effect) from corporate profits previously taxed at the standard rate will be smaller in the case of a tax cut in Basel-Stadt given that only 19% of the profits would benefit from a lower uniform tax rate. The canton of Fribourg is also planning a sharp reduction in the profit tax rate: although only 18% of income stems from special-status companies, their burden – and the risk of an exodus – will increase markedly given Switzerland's lowest average rate of just under 4% (including direct federal tax).

The cantons of Zug and Schaffhausen are unlikely to come under much pressure given that their standard profit tax rates are already among the lowest in the country. In this respect, Neuchâtel has emerged as a pioneer among the French-speaking cantons: back in 2011, the canton decided on a gradual reduction in its standard profit tax rate. This was set at 15.6% effective January 1, 2016. Meanwhile, with their significantly lower share of tax receipts from special-status companies, the other cantons are likely to come under indirect pressure in particular: if cantons cut their standard tax rates in turn, competition for companies already taxed at the standard rate will also be given fresh momentum. Even after the CTR III, the federal government will receive 8.5% of the profits in the form of direct federal tax. In financial terms it will be affected by any exodus of companies as well as the envisaged increase in the cantonal share of direct federal tax from 17% to a likely 20.5% (approx. CHF 1 billion).

## Impact of CTR III | Fiscal Equalization

# Distortion of Equalization

With the CTR III, the importance of corporate profits within cantonal resource potential is also under discussion. The contributions made to the fiscal equalization system by the cantons of Vaud and Geneva are likely to rise.

### Impact on resource potential

The CTR III will impact on the national fiscal equalization (NFE) system. This is due to the method of calculating resource equalization – the key redistribution vehicle of the NFE: the strength of a canton's resources is measured not by its actual tax receipts but by its potential tax base. This includes income, assets, corporate profits – and with it the profits of special-status companies. A large portion of these profits are taxed at sharply reduced rates. Because the cantons can therefore utilize the profits of special-status companies on only a limited basis, they are of less importance within the resource potential.

### Possible distortion

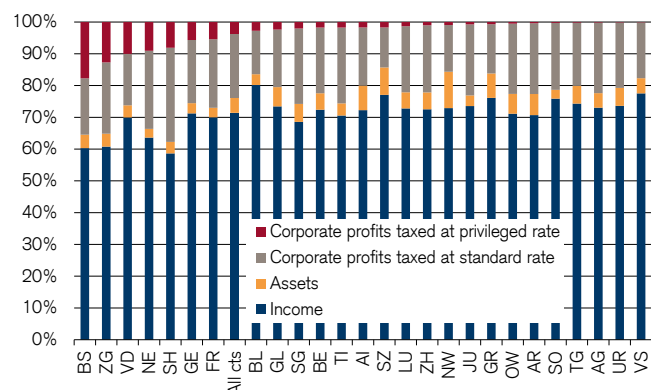
With the abolition of the privileges for special-status companies, their profits – in the absence of adjustment – would be added in full to the resource potential of a canton. Depending on the canton this would cause a rise or fall in the cantonal resource index, which shows resource potential compared with the national average. Special-status companies are concentrated above all in cantons with a high level of resources. In five of the nine NFE donor cantons, the abolition of tax privileges would result in a further increase in the resource index: 25% in the canton of Vaud, 10% in Geneva and as much as 50% in the canton of Zug, already the canton with by far the greatest resources. The resource index for nearly all NFE recipient cantons, on the other hand, would fall by around 10%. This is not because there would be any change in their potential but is due to the rise in the overall Swiss average.

### Lower utilizability of corporate profits

How much tax can the cantons take from corporate profits? The CTR III brings this question to the fore, because the utilizability of all corporate profits is currently around one third below the average utilizability of the incomes of private individuals (see chart). Reasons include the high mobility of international companies as well as tax competition. Although government therefore takes in less tax receipts per Swiss franc of profit than per Swiss franc of income, corporate profits – with the exception of those enjoying privileged status – are included in the resource potential in full. This too primarily affects cantons with a high level of resources, as far higher corporate profits are generated in these cantons.

### Varying importance of taxable profits...

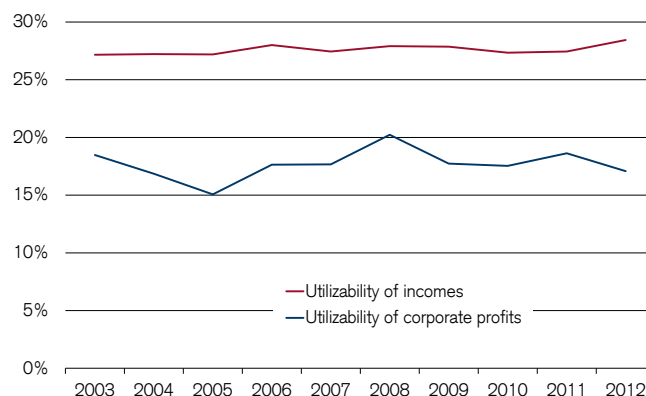
Composition of assessment basis for NFE resource potential (2015), ranked by share of privileged profits



Source: FFA, Credit Suisse

### ...and lower tax utilizability

Effective tax receipts as a share of taxable income/profits in accordance with NFE resource potential (average of all cantons)



Source: FFA, Credit Suisse

### Correction due to CTR III

In the absence of countermeasures, the overestimation of the resource potential by the CTR III is likely to increase: many cantons intend to lower their tax rates, as a result of which the tax utilization of profits would continue to fall. This is to be corrected in the calculation of the resource potential with the CTR III. The theoretically possible tax utilization is difficult to gauge, however. Corporate profits are therefore to be weighted within resource potential on the basis of effective taxation: the «zeta factor» equals the difference between the average tax rate on corporate profits and the rate on income. According to the federal government's simulation it is around 40%.

### Payments by Vaud and Geneva to increase

Assuming the current profit volume (including future profits of special-status companies taxed at the standard rate), the resource potential of the canton of Vaud would increase by 9%, despite the lower weighting of corporate profits, and that of Geneva by 4%. Instead of CHF 113 per resident, Vaud would have paid CHF 246 per resident into resource equalization in 2015 and Geneva CHF 782 rather than CHF 777. Meanwhile, the payment by the canton of Zug would have risen from CHF 2,792 to CHF 3,120. Within the group of NFE donor cantons, there would be relief for Zurich, Schaffhausen and Basel-Stadt: their resource potential falls slightly due to the weighting with the zeta factor. Meanwhile, Schaffhausen would move from being an NFE donor to an NFE recipient.

### Ensuring minimum resource provision

Due to the lower weighting of corporate profits, the Swiss-wide resource potential is likely to fall with the CTR III – and with it the minimum resource provision specified by the NFE in terms of Swiss francs and centimes. According to the NFE, the canton with the weakest resources – currently Uri – is to be raised to 85% of the Swiss average. To ensure this level is reached, the relative stipulation of 85% is to be temporarily replaced by a nominal target figure. In addition, a supplementary contribution is planned for the weakest cantons. This will be funded from freed-up resources from the hardship equalization system that was decided when the fiscal equalization system for cantons with a low level of resources was introduced. In its place Geneva and Vaud are calling for a «hardship fund» that would not only benefit the weakest cantons but also those most heavily affected by the CTR III.

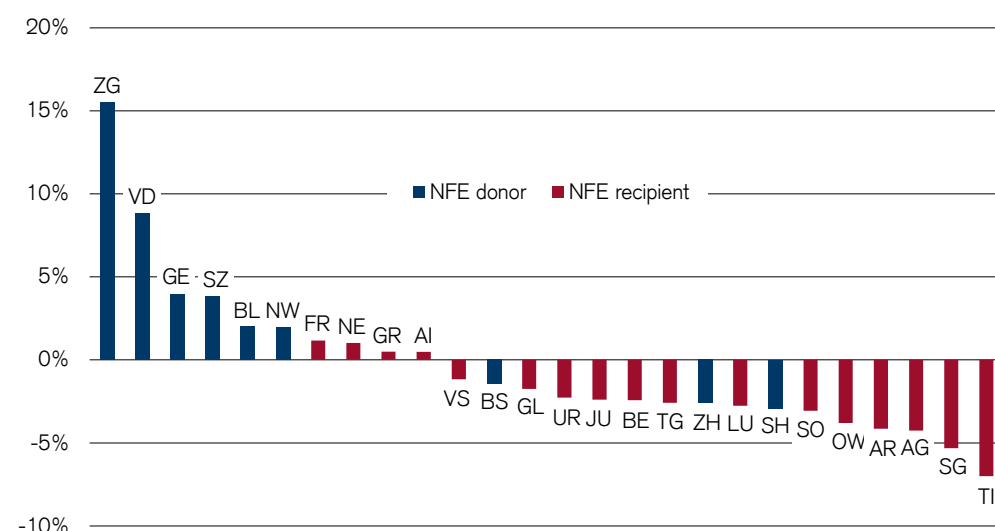
### Temporary departure from NFE principles

Both measures – weightings based on actual tax receipts and a nominal target figure for equalization – represent a departure from the principles of the NFE: a canton is not supposed to be able to influence its equalization payments through its tax policy, and equalization must always take place on a relative basis. The risk of disincentives is likely to be minimal, however, according to the Federal Council, given that even major changes in the tax policy of an individual canton are only mildly evident in the uniform, Swiss-wide zeta factor.

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### CTR III corrects weighting of profits in resource potential

Change in NFE resource index following CTR III



Source: FFA, Credit Suisse



## Summary

# Reform from a Position of Strength

### CTR III: a lot at stake

The Corporate Tax Reform III is one of the most important steps taken by Switzerland to renew its reputation as a business location. The reform is taking place due to long-standing external pressure. A quick solution is nevertheless in the best interest of Switzerland: otherwise retaliatory measures may follow, along with a loss of legal and planning certainty. In terms of the alternatives to the CTR III, the disadvantages dominate. Rapid action is required, as any referendum could delay the legislative process. In addition to the pending implementation of the «mass immigration initiative» and uncertainty about the bilateral agreements, confidence in Switzerland as a business location would be weakened.

### Switzerland in a position of strength

In the short term, the reform harbors risks including a shortfall of receipts for government and an exodus of the tax base. But in addition it also creates opportunities for Switzerland's positioning in terms of tax competition:

- Healthy government finances at federal and cantonal level enable investment in locational appeal. Other locations have significantly higher levels of debt and their opportunities are therefore limited.
- Patent boxes are aimed at innovative companies and could additionally strengthen Switzerland's (already very distinctive) position as a center for research and creative thinking.
- The OECD's BEPS action plan is likely to be a challenge for rival locations too. Switzerland need not worry about competing on a level playing field.

### Tax cuts: a long-term investment

The change of system to the CTR III is associated with tax shortfalls for the French-speaking cantons in the medium term. As an investment in the future of the business location, the reforms could pay off in the long term. The gap in attractiveness versus neighboring European countries is likely to widen. Although this is not the objective of the new tax policy, the relief provided will lead to a reduction in costs for companies doing business in Switzerland. The CTR III necessitates a rethink on the part of the cantons of Vaud and Geneva. Tax attractiveness will in future need to be achieved mainly via standard tax rates and no longer via privileges. The regional economy is likely to gain continuity: in the case of temporary tax holidays – which remain widespread in Vaud – there is a risk that the companies concerned will relocate after the tax breaks expire.

### No premature rejection of recognized tax instruments

In order not to fall behind other locations, the federal government should carefully examine internationally accepted tax instruments in future too. Switzerland missed an opportunity in the case of tonnage tax, which could be of interest to Geneva in particular. A premature rejection of such instruments is not advisable. They could be used to reduce the pressure on profit tax rates and therefore the knock-on effects.

### Success of reform depends on individual decisions

If Geneva and Vaud reduce their standard rates of profit tax to the target levels they will represent exceptionally attractive corporate locations – for international businesses as well as those operating on a Swiss-wide basis. The question of whether the planned moves are enough to prevent migration of the tax base cannot be answered conclusively at present, as there is still too little information about the individual decisions of companies and the tax changes abroad. The cantons of Vaud and Geneva are likely to gain in strength through the planned investments in tax attractiveness, with the result that future OECD action plans harbor fewer risks.

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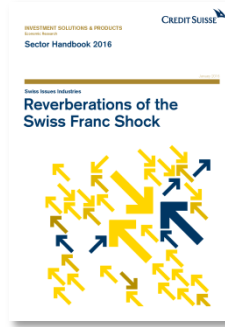
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