Taxation in the Canton of Zurich

Corporate Tax Reform III (CTR III): Update

Contact:

Regarding CTR III
Cantonal Tax Office Zurich
Head Corporate Tax
Bändliweg 21
CH 8090 Zürich
Tel  +41 (0)43 259 11 11
Fax  +41 (0)43 259 41 08
www.steueramt.zh.ch
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Introduction

Please find below a short summary and update of the latest main developments in connection with the corporate tax reform III (CTR III).

On June 17, 2016 the final corporate tax reform package (CTR III) passed the Swiss parliament. The CTR III packages include notable tax reform measures on federal as well as on cantonal/communal level. CTR III aims to strengthen Switzerland as an attractive tax and business location. The proposed measures shall ensure that Swiss corporate tax system will remain internationally accepted, competitive and sustainable.

The changes in tax legislation and regulation are intended to enter into force on January 1, 2019. However, it seems very likely that the CTR III will be subject to a referendum with public voting on federal level.

In its press release dated June 30, 2016, the cantonal council announced the planned strategy in connection with the new cantonal tax incentives offered through CTR III. The Zurich cantonal council intends to make full use of all possible tax incentives offered by CTR III to the maximum extent possible. However, the introduction of the below mentioned tax incentives requires an amendment of the Zurich cantonal tax law, which presumably will be subject to a public voting in autumn 2018.

1 Federal tax law

1.1 Notional interest deduction (NID)

CTR III plans to introduce on federal level an interest deduction calculated based on the equity exceeding a certain amount (surplus equity).

In general the applicable rate for the calculation of the NID is based on the long-term Swiss bond rate for 10 years. As far as the surplus equity is to be allocated to intra-group receivables, the applicable interest rate is calculated based on the arm’s length principle.

The Finance Department is mandated to enact the respective rules of implementation.

1.2 Disclosure of hidden reserves / Step-up procedure in general

According to CTR III hidden reserves shall be disclosed in the tax balance sheet at the beginning and the end of the tax liability.

A step-up is generally foreseen in case of a relocation of the legal entity or place of effective management to Switzerland. The same rule applies if assets or functions are transferred into a Swiss company or Swiss branch. The termination of a federal tax exemption also qualifies as a beginning of tax liability. Consequently a step-up should also apply in this case.

A step-up is applicable on hidden reserves including original goodwill. No step-up is foreseen on hidden reserves of investments in a corporation or cooperative of more than 10%. The depreciation rate for the disclosed hidden reserves is the same as the respective applicable maximum tax depreciation rate according to the official guidelines. The amortization period for goodwill is foreseen to be 10 years.

As a corresponding rule, hidden reserves (including hidden reserves on original goodwill) have to be taxed at the end of the tax liability, i.e. transfer of assets or functions abroad or relocation to another country.

2 Zurich cantonal tax law

Due to international development the cantonal tax regimes such as holding company, mixed company and domicile company are to be abolished for complying with international standards. During a transition period of 5 years hidden reserves and goodwill can be subject to a lower tax rate according to CTR III in case of realization. Within CTR III as a compensation for the abolishment of these tax regimes, new competitive and internationally accepted instruments should enter into force, e.g. tax incentives for research
and development, the patent box and the notional interest deduction. Moreover, a general reduction of the corporate income tax rate is intended.

### 2.1 General tax incentive: Reduction of cantonal corporate income tax rate

The cantonal council announced a planned reduction of the corporate income tax rate from currently 8% down to 6%. As a result, the effective tax burden for an ordinarily taxed company in the canton of Zurich with domicile in Zurich will be reduced from 21.1% down to 18.2% (federal, cantonal and community tax, calculation based on profit before taxes and current conditions, assuming a cantonal income tax rate of 6%).

### 2.2 CTR III tax incentives

On cantonal level in particular the envisaged tax incentives for research and development, the patent box and the notional interest deduction are interesting tax reductions in accordance with effective activities and complying with international standards.

These instruments can be combined with a cantonal tax holiday (provided the requirements for a tax holiday are met – see section 3 below). However, based on federal regulations, in any case at least 20% of the net earnings must be subject to taxation on cantonal level (provided no deductible tax loss carry forwards exist). The absolute minimum of 20% also applies, if tax depreciations are recorded on hidden reserves, resulting from a step-up of assets in connection with the loss of a tax regime (holding company, mixed company and domicile company). The cantonal council intends to go for the absolute minimum of 20%. Consequently profits are subject to a minimal effective tax burden of currently 10.1% (whereof only 24.5% relate to cantonal/communal taxes).

However, if the requirements for the NID are fulfilled on federal level, the effective final tax burden will be even lower than 10.1%.

#### 2.2.1 Tax incentives for research and development

According to CTR III the cantons have the possibility to allow on cantonal level increased tax deductions of maximum 150% of the effective research and development (R&D) expenses incurred in Switzerland (i.e. incurred in Switzerland directly by the company or indirectly through third parties in Switzerland). The Federal Council is mandated to define qualifying R&D expenses in the respective rules of implementation.

Based on the strategy of the cantonal council, a deduction of basically 150% of the effective R&D expenses incurred in Switzerland is envisaged. The exact amount of percentage depends on the calculation details and the definition of R&D expenses based on the provisions of the Federal Council.

#### 2.2.2 Patent box

On cantonal level a patent box shall be introduced. Thus, the portion of the income resulting from patents and similar intangibles related to Swiss incurred research and development can be released up to 90% from the cantonal corporate income tax. The Federal Council is mandated to enact provisions, in particular regarding the definition of similar intangibles, the calculation of the qualifying income from patents and similar intangibles and the required documentations to apply for the release.

The cantonal council outlined his intention to fully grant a 90% release on such income.

#### 2.2.3 Notional interest deduction

As outlined above (see section 1.1) CTR III plans to introduce on federal level an interest deduction calculated based on the equity exceeding a certain amount (surplus equity). The cantons can introduce the NID on cantonal/communal level if certain criteria are met, e.g. dividend income of private individuals holding an investment of more than 10% have to be taxed at least 60% under individual income tax.
In general the applicable tax rate for the calculation of the NID is based on the long-term Swiss bond rate for 10 years. As far as the surplus equity is to be allocated to intra-group receivables, the applicable interest rate is calculated based on the arm’s length principle.

The Federal Finance Department is mandated to enact the respective rules of implementation.

As the cantonal council announced, the NID shall be introduced in the canton of Zurich (and the necessary adjustments to meet the requirements shall be made, i.e. adjustment of the income taxation of certain dividend income from investments held by individuals).

2.2.4 Disclosure of hidden reserves / Step-up procedure in general

General:

According to CTR III hidden reserves shall be disclosed in the tax balance sheet at the beginning and the end of the tax liability.

A step-up is generally foreseen in case of a relocation of the legal entity or place of effective management to Switzerland. The same rule applies if assets or functions are transferred into a Swiss company or Swiss branch. The termination of a cantonal tax exemptions also qualifies as a beginning of tax liability. Consequently a step-up should also apply in these cases.

A step-up is applicable on hidden reserves including original goodwill. No step-up is foreseen on hidden reserves of investments in a corporation or cooperative of more than 10%. The depreciation rate for the disclosed hidden reserves is the same as the respective applicable maximum tax depreciation rate according to the official guidelines. The amortization period for goodwill is foreseen to be 10 years.

As a corresponding rule, hidden reserves (including hidden reserves on original goodwill) will also be taxed at the end of the tax liability, i.e. transfer of assets or functions abroad or relocation to another country.

Transition from preferential taxation to ordinary taxation:

As the special cantonal tax regimes (holding company, mixed company and domicile company) should be eliminated through CTR III compensation measures are foreseen. Thus, during a transition period of 5 years hidden reserves and goodwill should be subject to a lower tax rate. During this period the realization of hidden reserves (including original goodwill) can be recorded separately with a lower special tax rate, if such income would not have been taxable under the old law. Further details have to be determined by the cantonal legislature.

The Zurich cantonal council announced a planned special tax rate of 1% at maximum.

However, companies which are currently subject to special taxation in the canton of Zurich have the possibility to voluntarily waive their cantonal tax privilege prior to the enter into force of CTR III. In this case, due to cantonal tax practice a tax free step-up of hidden reserves (including original goodwill) is possible, followed by a tax-effective amortization (amortization of 10 years for goodwill). However, such deprecations are subject to the overall limitation of 80% of the tax relief, once CTR III is in force.

2.2.5 Reduction of capital tax

As a further measure in connection with CTR III, the cantons can envisage a reduced capital tax on equity relating to investments, patents and similar intangibles as well as intercompany loans.

2.3 Summary

In short, the strategy of the cantonal council intends the following tax incentives regarding the current taxation:

- Reduction of corporate income tax rate down to 6%;
- Deductions of 150% of the effective Swiss related R&D expenses;
- Exemption of 90% of qualifying income from patents and similar intangibles related to R&D costs incurred in Switzerland;
- Introduction of the NID;
- Reduced capital tax rate for a certain portion of the equity;
- Special tax rate on certain hidden reserves of holding, domicile and mixed companies for five years.

As a result of the combination between general reduction of tax rate from 8% to 6% and the other instruments (even without considering the NID on federal level and without considering the separate tax rate for certain hidden reserves), depending on the specific business activity a further reduction of the effective tax burden of 18.2% is within the scope, with a minimum of 10.1%, (federal, cantonal and community tax, calculation based on profit before taxes and current conditions, assuming a cantonal income tax rate of 6%).

3 Tax holiday

3.1 Federal tax holiday area in the canton of Zurich

As of July 1, 2016 the Zurich's communities of Rüti and Dürnten are part of the tax holiday area on federal level. Consequently, in case of relocation to these communities, a tax holiday for federal corporate income tax might be applicable, if the necessary requirements are met.

3.2 Cantonal/communal tax holiday

A cantonal/communal tax holiday can be combined with the above mentioned cantonal/communal tax incentives. For further information, please see our separate brochure „Tax relief to newly established business“.