Change of status from privileged to ordinary taxation

The change of status from privileged to ordinary taxation can already be envisaged before a revised version of the Corporate Tax Reform III (CTR III) enters into force. Fabian Duss and Marc Dietschi of **ADB Altorfer Duss & Beilstein** explore this possibility and outline why it could prove beneficial for businesses.

Switzerland's corporate tax law recently faced substantial pressure from the EU, the OECD and G20 member states. As a consequence, the CTR III was initiated a few years ago. The CTR III was subject to a referendum on February 12 2017 but was not supported by a majority of the Swiss voting population. Irrespective of this result, it is to be expected that the cantonal preferential tax regimes available in Switzerland (e.g. holding companies, mixed companies and domiciliary companies) will be abolished over the coming years due to international pressure. In any case, it is anticipated that a revised bill, including several measures already foreseen by the CTR III, will be published shortly. This article focuses on the possibility of a change of status from privileged to ordinary taxation before a revised version of the tax reform enters into force.

Background

Switzerland has a long-standing track record as one of the most attractive locations when it comes to corporate income taxation in Europe. The corporate income tax rates, although varying quite considerably between different cantons and municipalities, are generally moderate (between 12% and 24%, likely even subject to further reductions). Moreover, there are numerous possibilities to defer corporate income taxation by means of accelerated depreciation schemes, lump-sum valuation allowances on assets and accounting for provisions.

In addition, Switzerland's corporate tax law includes several preferential tax regimes, leading to an even more attractive taxation of income from certain mobile functions such as group financing, exploitation of intellectual property and international trading activities. Faced with pressure from the EU, the OECD and G20 member states, the preferential tax regimes were reviewed in recent years. The analysis led to the conclusion that the preferential regimes are no longer in line with international best practice and it was therefore decided to abolish them.

In order to preserve Switzerland's reputation as an attractive location for corporate taxpayers, several countermeasures were analysed. The latest developments in international taxation, in particular the OECD's BEPS reports, were taken into consideration. The government intended to abolish the preferential tax regimes and to replace them with countermeasures that are fully compliant with the BEPS reports as part of the CTR III. However, the reform was not supported by a majority of the Swiss voting population on February 12 2017. As a result, the tax legis-

lation remains unchanged. It is now expected that a revised bill with adapted content will be prepared but it is rather unclear how long it will take until the new reform proposal will be available. Due to the concessions made to the EU and the OECD, it is expected that the preferential tax regimes will be abolished irrespective of further developments in connection with the tax reform in the coming years.

Change of status

The change of status from privileged to ordinary taxation is an immediate consequence of the abolishment of preferential tax regimes, one of the measures foreseen as part of the CTR III. However, a change of status from privileged to ordinary taxation is already possible today, i.e. a privileged tax status can be abandoned voluntarily before a preferential regime is abolished. The question is how hidden reserves that have been built during a preferential regime will be treated upon transition into ordinary taxation. The CTR III contained specific rules for this exercise and this measure of the tax reform was undisputed.

It needs to be considered that the question of the realisation of hidden reserves does not only crop up in the context of changes from privileged taxation to ordinary taxation, but also for companies moving to and from Switzerland. According to the rules foreseen by the tax reform, hidden reserves can also be released tax neutrally in case of relocations to Switzerland or transfer of functions into Switzerland.

Applicable law

From a tax planning perspective, it is interesting to note that, in certain cases, a voluntary change of status before preferential tax regimes are abolished can be advantageous. The change of status will become mandatory for all companies benefitting from tax privileges once the revised tax reform enters into effect, at the latest.

Functionality

In case of a change of status, the tax treatment of hidden reserves depends upon the respective cantonal tax law and practice. The change from privileged taxation as a holding, mixed or domiciliary company to ordinary taxation only affects cantonal taxes. Some cantons have issued respective regulations. However, the practice of the cantons is not consistent. In principle, two models are applied, as outlined below:

- Step-up in basis of assets comprising hidden reserves generated during the time of a tax privilege (so-called "step-up" model): The hidden reserves are realised for tax purposes by way of a tax-neutral step-up in basis at the time of the change of status. The assets concerned are then amortised over a specified period of time. The step-up and corresponding amortisation will only be represented in the tax balance sheet, i.e. no commercial accounting takes place. Amortisation of the realised hidden reserves leads to a reduction in the taxable profit on cantonal level. However, thought should also be given to the fact that the step-up does result in an increased capital tax basis. Further, companies applying accounting standards that are in line with the "true and fair view" principle (e.g. IFRS, US GAAP) are subject to a one-time effect in the form of deferred tax income as a result of the step-up; and
- Determination of hidden reserves generated during the time of a tax privilege (so-called "pro memoria" model): The amount of hidden reserves is determined at the time of the change of status. When realised at a later point in time, the hidden reserves are not, or only partly, subject to ordinary taxation, as they were generated during the time of a tax privilege. A "pro memoria" model was also foreseen under the CTR III.

Arising questions

The specific features of these two models differ according to the practices of the individual cantons. However, the following key questions arise in either model:

- Which valuation method will be used to quantify the hidden reserves?
- How is self-generated goodwill treated?
- What is the effect on hidden reserves on specific assets (e.g. real estate or participations) in cases of a change of status?
- How long will the transitional effect (e.g. amortisation period) last?
- What is the effect on tax losses carried forward?

Only certain cantons (e.g. Zurich, see below) have published specific local directives that deal with the change of status and, in particular, the step-up and release of hidden reserves generated during the time of a cantonal tax privilege.

In the absence of corresponding legal provisions, the approach for determination of the company value and, therefore, the amount of hidden reserves should be identical for both models. In any case, a recognised valuation method should be applied (e.g. so-called "*Praktikermethode*" as published in a circular letter of the Swiss Tax Conference or a discounted cash flow approach).

Practice of the canton of Zurich

The canton of Zurich has taken up the questions above and issued an official note on September 22 2016 regarding the change of status from privileged to ordinary taxation by way of a step-up. The note stipulates the following:

- A company can release its hidden reserves (to the extent of a prior tax exemption) at the time of a change of status

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without tax consequences and amortise the hidden reserves going forward. The hidden reserves released are subject to capital taxes at cantonal level (provided they have not been amortised in prior years). Capital taxes will no longer be calculated using privileged tax rates. The voluntary release of hidden reserves is possible up to the last tax year before the (revised) tax reform enters into force;

- In general, hidden reserves can only be released tax neutrally to the extent that they have been created under a tax privilege. As a consequence, hidden reserves on real estate of holding, domiciliary or mixed companies cannot be released tax neutrally (since income from real estate is subject to ordinary taxation under all tax regimes). Hidden reserves on assets of domiciliary or mixed companies can only be released tax neutrally to the extent of the applicable (i.e. tax exempt) quota of foreign income. In relation to qualifying participations of holding, domiciliary or mixed companies, only the difference between initial acquisition costs and corporate income tax values is affected by a change of status. The reason behind this is that the participation exemption applies for the difference between initial acquisition costs and sales proceeds (i.e. this difference is tax free).
- For cantonal tax purposes, losses incurred under the tax privilege of holding companies can no longer be offset after a change of status. Losses incurred under the tax privileges of mixed or domiciliary companies can only be offset with future profits to the extent of the previous taxable quota (note: ordinary taxation applies at federal level under the cantonal tax regimes mentioned); and
- The hidden reserves released as part of a change of status must be amortised within 10 years. The amortisation is subject to the maximum relief of the cantonal tax base of 80% as foreseen by the CTR III (note: this rule was mandatory for all cantons under the CTR III. However, a new reform may not contain this restriction).

In any case, a voluntary step-up should be discussed with the respective tax authorities in advance, i.e. a binding tax ruling regarding the amount of the step-up, the allocation of hidden reserves to the assets as well as the amortisation period should be obtained.

New law

The CTR III did foresee a uniform regulation for all cantons for the treatment of hidden reserves in case of a change of status to ordinary taxation. This regulation will likely not change in principle under a revised corporate tax reform.

According to the legislation of the CTR III, it is intended that the amount of hidden reserves will be determined at the time of the change of status (pro memoria model). This will be done by means of an assessment. Companies will receive a questionnaire on the existing hidden reserves. Once returned, the amount of hidden reserves will be examined and determined by way of assessment. It is thereby explicitly stated that hidden reserves also include self-generated goodwill. Insofar as the determined hidden reserves are realised within five years following the change of status, they will be subject to a special, lower tax rate. The level of the applicable tax rate for the five-year period is to be determined by each canton individually.

Companies should undertake analysis

As described above, there might be significant differences between existing regulations and practices of the cantons and the legislative text foreseen by the CTR III when it comes to the change of status from privileged to ordinary taxation. As the approach in a revised tax reform is likely to be similar to the version of the CTR III it is worthwhile for companies to compare the scenario of an early voluntary change of status from privileged to ordinary taxation based on actual and budget figures. Depending on the actual facts and circumstances, the step-up model appears to be more advantageous since all hidden reserves can be used for subsequent amortisation (at least in case there will be no limitation of the amortisation period based on cantonal regulations or based on the tax reform). In the model, according to the CTR III, the particular question arises as to if and to what extent the hidden reserves can be realised within the timeframe of five years.

The abolishment of the tax privileges is in any case necessary in order to avoid further pressure from both the EU and the OECD. Therefore, a potential change of status for companies benefitting from a cantonal tax privilege should be analysed now as part of the tax planning process.

Revised tax reform being prepared

The opponents of the CTR III only disagreed with certain measures of the reform, namely the notional interest deduction and the insufficient increase of the taxation of dividends at the level of individual shareholders. As such, the reform and the other measures of the CTR III were not disputed.

This particularly applies for the abolishment of the preferential tax regimes. Therefore, it is expected that a revised draft with adapted content will be prepared soon. If these two aspects mentioned above will be amended, it may be possible to get the revised bill passed shortly, but only time will tell when those changes can effectively be implemented. The Swiss Federal Council announced that the key elements of the revised reform will be communicated by the end of June 2017. However, it is unlikely that the reform will be ready by the beginning of 2019. Instead, a delay between one to three years has to be anticipated.

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