Tax incentives for manufacturing

Rolf Wüthrich of Vischer explains how the Swiss system benefits foreign investors

When choosing a location for setting up an enterprise, one of the important issues to be considered next to infrastructure are the taxes imposed in a specific jurisdiction. The tax environment is a key factor in deciding on a location for a company. In a world with international competition, tax considerations play an increasingly decisive role in the choice of business location. Therefore, tax incentives may have a significant impact in the process of choosing a new business location by international groups.

With effect from January 1 2008, the Swiss government has implemented new legislation to promote economically weaker regions within Switzerland. The new legislation contains various measures to strengthen such areas, including the possibility of granting tax exemptions for federal income tax purposes for up to 10 years. The legislation has replaced the so-called Bonny-Decree, under which it was possible to apply for tax holidays in the past.

Economic investment incentives, such as the granting of tax holidays, are offered by all cantons for projects bringing new industry into the respective region that create jobs. The federal government may also offer economic incentives in designated regions for certain types of project. As a result, investors are encouraged to look carefully into the potential options available.

Economic investment incentives in Switzerland notably include tax holidays for up to 10 years on qualifying projects. The process is a political one involving the designated authorities in the respective canton as well as the federal government (to the extent federal incentives are pursued). Next to the number of working places created by a specific project, the contribution to the regional creation of value and the technological development are the crucial considerations in the decision on the extent of a tax holiday granted.

In the past

Tax holidays are not a new instrument in Swiss law. As a result of the crisis in the Swiss watch industry in the 1970s, the Swiss federal government issued in 1978 a decree to stimulate economically suffering areas (the so-called Bonny-Decree), which allowed the granting of tax holidays in specific Swiss areas that were dominated by a mono-structured industry (watch and textile industry). The application of the Bonny-Decree was time-limited until 1984, but was extended three times, in 1984, 1995 and 2001. With each extension in duration, the areas to which the decree applied were also enlarged.

With the entry into force in January 1 2008 of the new federal law on regional policies the application of the Bonny-Decree expired. The new legislation, however, contains detailed regulations on the granting of tax holidays for federal tax purposes to promote private investments in certain regions within Switzerland.

> **Tax considerations play an increasingly decisive role in the choice of business location**

The swiss tax system

When simplified, there are two levels of corporate taxation in switzerland. Taxes are levied on enterprises by the federal government and by the cantonal governments. The cantons are free to decide which taxes are levied from legal entities, unless the swiss federal constitution specifically bars them from collecting a given tax or reserves the exclusive right to do so to the federal government. As a result, legal entities are subject to corporate income tax at a federal level and to corporate income and capital taxes at the cantonal level.

Cantonal tax holidays

The sovereignty of the cantons to levy taxes from enterprises is, however, restricted by the federal law on the harmonisation of direct cantonal and communal taxes (thl), which entered into force on january 1 1993. The thl constitutes a framework law, which overrules cantonal law. It contains basic fiscal principles, which must be applied by all the 26 swiss cantons. Article 23 thl states that cantons may grant tax holidays of up to 10 years, subject to the condition that a newly-established enterprise is in the economic interest of a canton. Thus, the cantonal governments may promote the founding of new companies that are of economic importance for a canton or a region by granting full or partial tax relief. Such privileges are always limited to a maximum period of 10 years. The tax relief applies to the cantonal taxes on profits and capital and varies from one canton to another. Nowadays, all cantons grant tax holidays based on article 23 thl.

Federal tax holidays

Next to cantonal tax holidays, it is also possible to apply for federal tax incentives. To benefit from federal tax holidays, however, the following conditions must be fulfilled:

- Cantonal tax holidays: To apply for federal tax holidays the applying legal entity must already have been granted cantonal tax holidays in accordance with Article 23 THL.
- Material scope of application: Only manufacturing or industrial legal entities or suppliers to such entities may apply for tax holidays.
- Geographical scope of application: The applying legal entity must carry out its project in a specific area as defined by the federal government.

Requirements for federal tax holidays

Cantonal tax holidays

To be allowed to apply for federal tax holidays a legal entity must already be granted cantonal tax holidays. Thus, only if the cantonal requirements for tax holidays according to Article 23 THL are fulfilled and a canton grants cantonal tax incentives, can federal tax holidays be applied for. However, federal tax holidays may never exceed the cantonal tax holidays granted in terms of scope and duration. Tax holidays will be granted only to legal entities.

Material scope of application

Tax holidays for federal corporate income tax purposes are only granted to manufacturing or industrial legal entities and to suppliers to such entities that are important for the economic development of a certain region ¬¬- that is, which create new workplaces or reorganise existing ones. Financial or advisory services are excluded from tax holidays.

Whether a project is of importance for a certain region is measured by the following:

- The amount of the planned investment in a region.
- The number of newly-created workplaces or the number of reorganised existing workplaces to ensure the long-term existence of such workplaces in a region.
- The creation of added value in a region.
- Innovation.
- The volume of purchase and orders of goods and services within a region.
- The cooperation with research and education institutes in a region.

To request tax holidays, it is necessary to have a business plan describing the planned investments, the creation of workplaces and the development of the business for at least a five-year period.

Federal tax holidays are only granted to manufacturing or industrial legal entities or suppliers to such entities that create new workplaces or reorganise existing ones. If the applicant is not a manufacturing or industrial company, but a supplier to such a company and if the investments planned within Switzerland are considered to be moderate, then tax holidays will only be granted if at least 20 workplaces will be created in Switzerland.

As mentioned before, tax holidays for federal tax purposes are linked to the granting of cantonal tax holidays. Thus, federal tax holidays will only be granted if a canton also grants such incentives and if the cantonal decision on the granting of cantonal tax holidays contains provisions on the duration of the incentives granted and the modalities for a possible repayment of the incentives if tax holidays are abusively obtained. Tax holidays qualify as abusively obtained if:

- An enterprise does not implement or realise the key elements of its business plan as agreed on with the canton.
- An enterprise realises a project that clearly differs from the originally defined project as described in the business plan.

Geographical scope

For cantonal tax purposes there are no limitations with respect to the geographical scope of an application for tax holidays. As it is in the discretion of a canton to grant incentives for cantonal tax purposes, cantonal tax holidays may be granted in all regions of Switzerland.

For federal tax purposes, however, the federal government has defined specific regions that it considers to be economically weaker and, as a consequence, in which federal tax holidays are granted. Compared with the regions defined under the Bonny-Decree, which applied in the past, the list of privileged areas has been shortened. It concentrates on rural regions, and no longer includes the suburbs of bigger Swiss cities. The new list covers various regions in 11 cantons of Switzerland.

Tax holidays are granted for the implementation of a legal entity's project, realised within one of the economically weaker regions in Switzerland. Thus, tax holidays are linked to the realisation of a project within a region, which may lead to limited Swiss tax liability in this canton. As the incentives are linked to a project, no unlimited tax liability (fiscal residence) of the investing legal entity is required in Switzerland. A legal entity that has headquarters abroad may apply for tax holidays to be granted to its Swiss permanent establishment for a specific project as long as the project will be realised within a region defined by the federal ordinance.

To avoid incentive shopping, though, no tax holidays are granted if an enterprise moves existing workplaces from one canton to another.

Scope

Federal tax holidays cannot be more generous than cantonal incentives granted with regard to scope, such as the grade of the tax exemption or the duration of the incentive. Thus, the conditions negotiated with the cantonal administration will set the maximum incentives that will be granted for federal tax purposes.

Tax holidays may be granted for a maximum period of 10 years, which includes the year of formation of the new Swiss company or the branch, as the case may be, and the following nine fiscal periods. The tax exemption is normally granted on a declining basis. Starting with a 100% exemption in the first one or two years, the exemption decreases over the 10 year- period on a yearly or two-yearly basis. If an entity applying for tax holidays does not qualify as a manufacturing or industrial company, but

Rolf Wüthrich
Vischer Attorneys at Law

Attorney at law, LL.M., Certified Tax Expert
Aeschenvorstadt 4, 4010 Basel, Switzerland
Tel: +41 61 279 33 00
Fax: +41 61 279 33 10
Email: rwuethrich@vischer.com

Domestic and international tax law, especially focused on: mergers and acquisitions, corporate reorganizations advanced tax rulings, US tax law and commercial law.

University of Bern (1998), Bar exam (1998); University of Leiden / International Tax Center, the Netherlands (LL.M in international taxation, 2001); Swiss Certified Tax Expert (2004)

Associate with the Amsterdam office of the International Bureau of Fiscal Documentation (IBFD; 1998 - 2001) and correspondent to the IBFD from 2002 until 2007. Lecturer at the Swiss Finance Institute for tax law (ongoing) Lecturer at the Robert Kennedy College, Zurich for tax law (ongoing). Lecturer at the Higher School of Education of the Northern Area of Switzerland for Swiss tax law and at the Swiss Financing Institute for wealth planning Member of the board of directors of Swiss subsidiaries of privately held companies as well as of public companies

Basel Bar Association, Basel Lawyers Association, Berne Lawyers Association, International Fiscal Organization (IFA), Swiss branch, Global Tax Organization (GTO), Alumni Association of the IBFD, Swiss Bar Association, Swiss American Chamber of Commerce, American Bar Association as a supplier to such a company, and if the investments planned in Switzerland by the applying company are considered to be moderate, then no 100% exemption will be granted; the incentive will normally be reduced to a 50% exemption. Should a canton revoke the cantonal tax holidays granted for whatever reason, the revocation automatically leads to analogous revocation of the federal tax holidays.

If no existing business is transferred, newly-established companies often realise losses in their first years of existence. As a result, it may seem that tax holidays will not bring any advantages from a tax point of view. Because losses may be carried forward for Swiss tax purposes for a seven-year-period and be offset during that period with future profits, tax holidays often do not bring advantages for corporate income tax purposes. However, as the cantons also levy a cantonal capital tax on the equity of a legal entity and as cantonal capital taxes are normally also covered by cantonal tax holidays, there is an advantage, especially for highly capitalised entities: if they apply for (at least cantonal) tax holidays, no capital tax will be due, while capital tax is still due in the case of loss-making entities without tax holidays.

Transition period

Until December 31 2010 it will still be possible to apply for tax holidays in the old regions (suburban areas of bigger Swiss cities) defined under the Bonny-Decree. However, should tax holidays be granted in one of the old regions, which no longer qualifies under the new legislation, then the tax exemption will be limited to a maximum of 50%.

Procedure

To apply for federal tax holidays companies must first apply for cantonal tax holidays. If the canton grants the incentive, the canton submits the request for federal tax holidays, together with its decision and an opinion on the planned project, to the State Secretariat for Economic Affairs. The State Secretariat for Economic Affairs reviews the request on behalf of the Federal Department of Economic Affairs. After consultation, the Federal Department of Economic Affairs issues a formal decision on the federal tax holidays to the requesting party. To secure the project, for which the incentives are granted, the decision may contain conditions and obligations. An interim evaluation regarding the realisation of the project may be requested.

The new legislation implemented by Switzerland offers an interesting opportunity for foreign investors to set up a Swiss manufacturing wing. Switzerland grants tax holidays of up to 10 years, which gradually decline over that period. The incentives granted may be attractive for foreign investors choosing a new business location within Europe, as Switzerland also has a highly-educated labour force. In addition to its liberal labour legislation, Switzerland is situated in the middle of Europe and has excellent international transportation connections. From an international tax point of view, Switzerland's tax treaty network, with about 90 tax treaties, offers the type of framework required by an international group of companies to act in international transactions.

For cantonal tax purposes, incentives are granted by all cantons. For federal tax purposes, only specific rural regions may benefit from the tax holidays. But as Switzerland is a small country and as the transportation infrastructure (train, highways, roads) is of a high standard, the restriction of tax holidays to specific areas does not disadvantage foreign firms investing in rural areas. Infrastructure costs will also be lower in such rural areas than in the economically developed areas of Switzerland.