Credit: Jos Schmid

How low can they go?

Tax competition between Swiss cantons has created an attractive environment for corporates but doubts are growing over whether this approach is sustainable over the long term.

Summary
Some Swiss cantons are competing to offer low tax rates and tax privileges to corporates. This has helped to make Switzerland a popular destination for corporate migration, but it has also drawn criticism from the European Commission on the grounds that it comprises unlawful state aid. In Switzerland, there is still fairly strong consensus that tax competition between cantons is positively influencing spending behaviors of cantonal governments.

▸ **By Sandra Willmeroth**

Tourists, for a long time, have been travelling to the picture postcard medieval city of Lucerne to enjoy the spectacular scenery and well-preserved medieval buildings. Even Mark Twain paid a visit in the 1870s and wrote about it in his travel book A Tramp Abroad. More recently, however, the canton of Lucerne has been attracting a new type of visitor – multinational companies in search of a low rate of tax. In September 2009, voters in the canton of Lucerne approved a revision of their tax legislation that would cut the corporate income tax from January 2012 to a record low of 4% to 6.5%, depending on the municipality. "We view tax relief as an investment in our canton's competitiveness," explains Hansruedi Buob, senior manager at the Lucerne Tax Office. He is convinced that, besides attracting new taxpayers, a consistent tax policy oriented towards promoting the attractiveness of Lucerne as a location will also provide significant benefit for private individuals and companies already resident there.

In some other parts of central Switzerland, this tax offensive caused considerable unease. The neighboring canton of Obwalden, which previously offered the lowest taxes in Switzerland as well as a flat personal income tax rate, quickly found itself under pressure to follow suit. The cantonal government in Obwalden is now contemplating cutting corporate tax rates even further from 2012 in order to compete with Lucerne. "Only the top position garners favorable publicity, which you don't get if you're ranked third or fourth," says Marianne Nufer-Brändle, head of the tax authority in Obwalden. In other words, Obwalden does not want lose its crown as the Swiss canton with the lowest tax rate to Lucerne. In recent years,

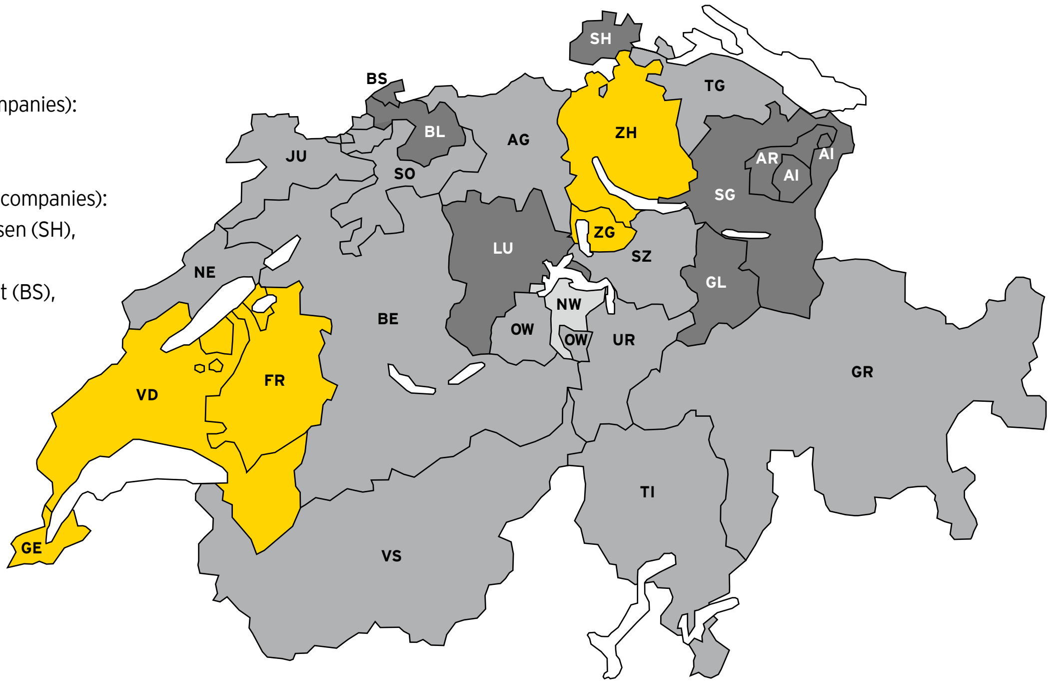
Martin Naville
Director of the Swiss-American Chamber of Commerce

How does tax competition between cantons affect multinationals?
Tax competition between cantons is first and foremost an advantage to international companies. It gives the companies assurance that their chosen location will continuously strive for advantageous fiscal conditions. But such competition is also a disadvantage with cantons trying to outdo each other, instead of making sure that companies choose Switzerland overall.
Does the current situation affect the willingness of companies to move to Switzerland?
The ongoing discussions with the EU regarding cantonal tax regimes create great uncertainties about future taxation, and, as we all know, certainty is a key success factor for Switzerland. More co-operation is needed; otherwise foreign companies will be confused by the divergent messages coming from this little landlocked country in the Alps.

Headquarter relocations: Swiss cantons are very competitive in attracting foreign companies

Hot spots for headquarters in Switzerland

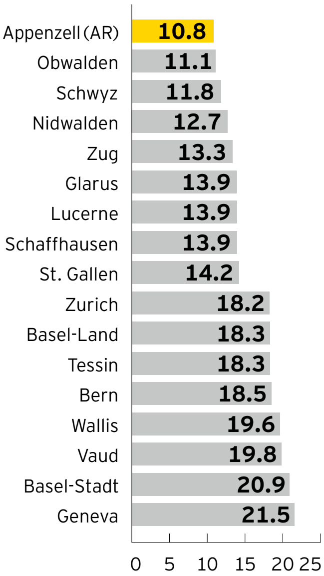
- **High level** (60% of total relocated companies): Zurich (ZH), Zug (ZG), Geneva (GE), Fribourg (FR), Vaud (VD)
- **Medium level** (29% of total relocated companies): Lucerne (LU), Glarus (GL), Schaffhausen (SH), Appenzell Ausserrhoden (AR), Appenzell Innerroden (AI), Basel-Stadt (BS), Basel-Land (BL), St. Gallen (SG)
- **Low level** (11% of total relocated companies): Bern (BE), Jura (JU), Neuenburg (NE), Schwyz (SZ), Aargau (AG), Graubunden (GR), Obwalden (OW), Solothurn (SO), Thurgau (TG), Tessin (TI), Uri (UR), Wallis (VS)
- **n.a. Nidwalden (NW)**



Source: Arthur D. Little headquarters database

BAK Taxation Index of Swiss cantons 2010

The table relates to combined effective corporate income tax rate (federal, cantonal and municipal).



Source: BAK Basel

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Obwalden's low tax policy has had a significant effect on its register of companies. Indeed, as Nufer-Brändle points out, the number of registered companies in the canton rose from 2,000 to 3,500 in the four years since the first income tax cut to 6.6%.

Other cantons are gaining in popularity such as Fribourg with its tax regimes governed by a flexible Administration. Schaffhausen offers a combination of proximity to the international airport and the city of Zurich, a low corporate tax rate and a quality of life enhanced by both its geographical location and its cultural history. This combination is enticing an increasing number of relocating companies.

The European Commission takes notice

Competition between cantons to attract companies with low tax rates has been ongoing for a number of years. This downward pressure on taxes has created a highly competitive tax environment in the country as a whole that has led to a large number of multinationals relocating either their global or European headquarters to Switzerland. Indeed, the foreign trade development organization OSEC Business Network Switzerland says that competition between cantons is "one of the main reasons why Switzerland is such an attractive location." According to Martin Naville, Director of the Swiss-American Chamber of Commerce (AmCham) and co-author of the study "Foreign Companies in Switzerland – The Forgotten Sector", foreign firms in Switzerland already account for around 10% of Switzerland's economic output. More than 50% of foreign head offices are American, including the oil drilling group Transocean, whose global headquarters has been based in the canton of Zug since 2008. Over the years a number of French and German firms have also migrated to Switzerland, with one early mover being logistics group Kühne+Nagel, which was formerly based in Hamburg. Among the Asian firms with their European or global headquarters in Switzerland, half are Japanese, with the BRIC countries (Brazil, Russia, India and China) also seen as having great potential for growth.

In addition to being able to vote on their own tax rates, Swiss cantons also offer tax holidays and tax privileges. Tax holidays are based on certain rules and regulations and require a formal decision by the government, because they are granted for macroeconomic reasons. The European Commission has been highly critical of some aspects of the tax privileges defined in the tax laws of the cantons. In February 2007, it informed Switzerland that it considered certain cantonal tax privileges in favor of holding companies, mixed companies or domiciliary companies to be unlawful state aid. The EU announced its intention to reach an agreement with Switzerland on a regulation to put an end to differential tax treatment of domestic and foreign income in Switzerland as well as the non-taxation of non-investment income generated by holding companies in the cantons. Since then, Switzerland and the EU have held several talks on cantonal tax privileges aimed at correcting the perceived distortion of competition. To date, however, no results from these negotiations have been announced.

"The differential treatment of profits depending on whether they are generated in Switzerland or abroad under the mixed company regime and certain aspects of the holding company regime are certainly questionable," says Dominik Bürgy, Managing Partner Tax at Ernst & Young Switzerland and Vice-Chairman of the Swiss Chamber of Certified Accountants and Tax Experts. "This is all the more reason for Switzerland to become proactive in adjusting the tax privileges in their current form so that they are more ostensibly aligned with EU standards."

Deterrents to corporate migration

Uncertainty over how this dispute will be resolved is deterring some companies from relocating to Switzerland because they fear that they will lose these special privileges. "At present, there is a great deal of legal uncertainty as to how the tax dispute with the EU can be settled," says Peter Baumgartner, Director of Swiss Holdings, a body that represents multinationals based in Switzerland.

Some commentators in Switzerland fear that an agreement with the EU requiring the cantons to abandon or adjust their special rules would also lead to an exodus of corporates to other jurisdictions. But Bürgy of Ernst & Young believes that these concerns are overestimated. "In my view, the risk of emigration may be mitigated by a combination of a low regular tax burden with EU-approved tax privileges, which at the same time will also continue to attract new corporations," he says. But while few companies may be willing to leave Switzerland, the numbers arriving have declined, with 54 making their way in 2008 and just 15 in 2009. The financial crisis has certainly added to uncertainty, with companies putting all major plans on hold while they dealt with the more pressing concerns of liquidity and, in some cases, solvency.

Martin Naville of AmCham points to the replacement of a law known as the "Lex Bonny" in 2008 as another important reason why corporate migration to Switzerland has slowed considerably. Previously, this law allowed cantons to give companies that relocate to economically weak regions a reduction in their tax base. But under the new Federal Act on Regional Policy that replaced Lex Bonny, state guarantees were abolished and industry-wide financial aid became integrated into the multi-year programs of the cantons.

In the longer term, most commentators agree that Switzerland will continue to be at the forefront of international tax competition and, for this reason, is likely to remain a highly popular destination for multinationals seeking a new headquarters. From a macroeconomic perspective, Switzerland has low levels of debt, which means that it has much greater fiscal flexibility as compared to most of the large European countries, where debt levels have mushroomed as a result of stimulus packages and bank bail-outs. This, in turn, is likely to lead to higher taxes in those countries, and this will make Switzerland appear even more competitive by comparison.

75m

A company that relocates to Switzerland boosts GDP by an average of CHF 75 million and creates around 450 new jobs within the country, according to OSEC, a Swiss business forum.

34%

Multinational companies account for about 34 percent of the total Swiss GDP. Of that, 10 percent is contributed by foreign multinationals.

But while the influx of firms is broadly welcomed in Switzerland, it does have a knock-on effect in terms of costs. According to a recent study by the Zurich University of Applied Sciences, residential property prices around Lake Geneva have tripled since 2000 and those in the Zurich region have doubled, with vacant rental properties being scarce. A similar effect has been registered in the central Swiss cantons of Schwyz and Zug, where property specialists at estate agent Wüest & Partner have even noticed native Swiss citizens being crowded out, because they can no longer afford to live in their home towns.

The political wind does appear to be changing slightly in the face of such developments. Some politicians, who until now have been unqualified supporters of tax competition, are raising the possibility of a rethink. There have been isolated voices calling for a "more healthy level" of tax competition and representatives of the higher tax cantons are requesting that the Government set a minimum tax rate. The rationale for doing this would be twofold: first, it would protect the cantons from a ruinous "race to the bottom"; and second, it will avoid conflicts over revenue sharing. Currently, structurally weak cantons receive equalization payments from financially powerful neighbors, even if they have previously enticed companies away from other cantons. With expected changes the mix of cantons giving and receiving such payments may change substantially.

A provocative call

Although there is widespread competition between cantons to set tax rates that will attract companies to move from one canton to another, it remains relatively rare for one canton to actively poach companies from another. There have been examples of a company being enticed from one canton to another, but often such a move is made for a variety of reasons, and rarely for tax purposes alone.

With international pressure on Switzerland's low-tax strategy mounting in the face of ongoing attempts by cantons to ratchet up tax competition, one might think that the argument had reached its logical conclusion. But in July 2010, the Swiss economic commentator Philipp Löpfe took it one step further. His provocative suggestion was to abolish corporate taxes in Switzerland, or at least at a cantonal level. In this way, he said, tax competition "would no longer be about Obwalden versus Lucerne, but about Switzerland versus the rest of the world." Tax competition, it seems, remains alive and well in this corner of Europe.