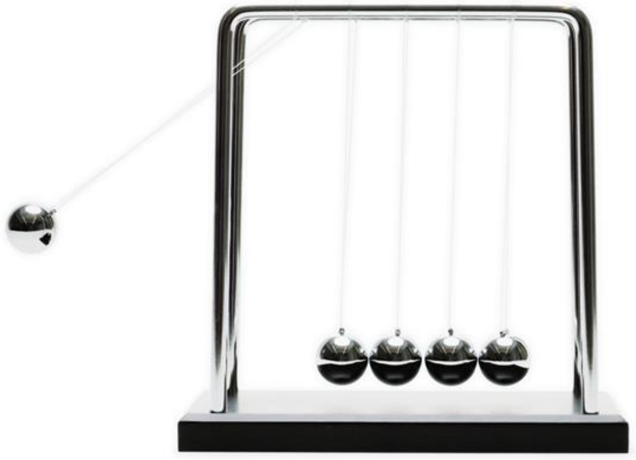
Swiss Corporate Tax Reform III



July 2014

Audit.Tax.Consulting.Corporate Finance.

Swiss Corporate Tax Reform III

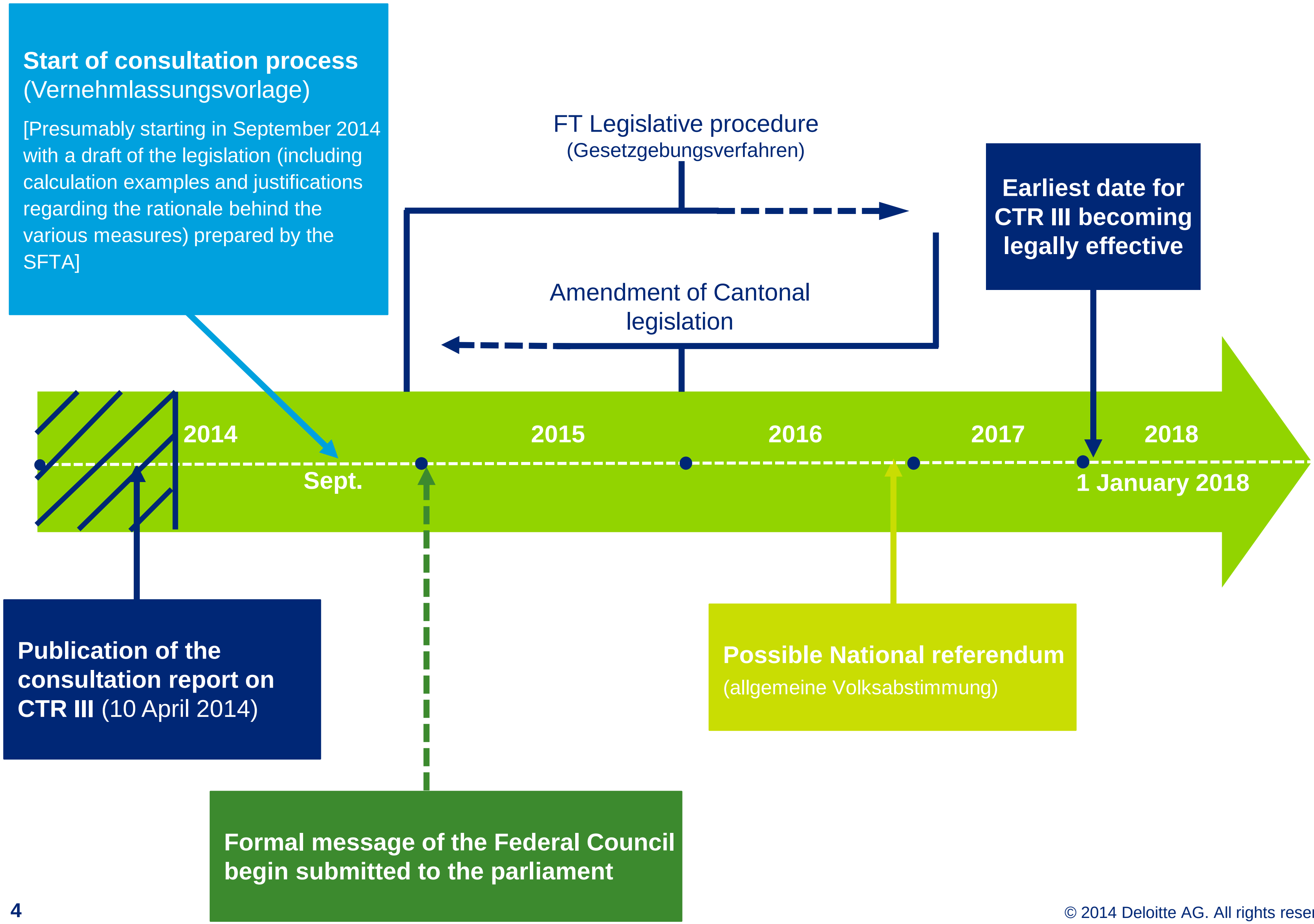
Swiss Corporate Tax Reform III

The following presentation represents the **current status of discussions in regard to the upcoming Swiss Corporate Tax Reform III** and is in particular based on the following reports:

- Recommendations by the Steering Committee in charge of Corporate Tax Reform III, dated December 11, 2013
- Report on the consultation with the Swiss cantons, dated April 10, 2014

The items discussed herein represent suggestions only, it is unclear to date if, to what extent by when and in which form the measures discussed herein will come into law.

Expected timeline until implementation



Overview Content CTR III

OECD | G20 | EU

are focusing on

Non taxation | Shifting of mobile income | Ring fencing

Impact on Swiss tax regimes

Holding company | Domiciliary company | Mixed company | Principal company | Finance Branch

Abolition of these regimes has to be compensated with concrete measures

General Focus of Corporate Tax Reform III

Objectives
- Maintain/ improve attractiveness of Switzerland
- Sustainability
- Economic balance

Strategic Direction
- Tax policy
- Finance policy

Elements of Reform
- Change of Corporate tax law
- Change of Financial Equalization
- Financing of tax reductions on corporate level

Impact on Financial Equalization mechanism
Abolition of tax privileged regimes and a general reduction of the tax rate will affect cantons differently and will require a change in the inter-cantonal Financial Equalization mechanism

Vertical (federation vs. cantonal) compensating measures
- Tax reduction at federal level
- Increase of assessment base direct taxation
- Amendment of tax revenue allocation between federation and cantons

Compensating financing at federal level
- Spending reduction
- Revenues:
  - Capital gains tax on participations
  - Increase VAT rate
  - Widening of assessment base
    - Less deduction
    - More tax audit/tighter controls

Possible tax policy measures

New regimes for mobile income

Interest adjusted income tax
«Equity eligible for interest adjustment». Proposal:

Core Equity | **Safety Equity**

Equity portion that exceeds Core Equity - and on which an interest deduction/adjustment will be granted.

Rate of allowed interest deduction?
- Jurisdictional attractiveness vs.
- Loss in tax revenues

License Box
Narrow or broad definition of license income (Aim: As broad as possible while monitoring loss in tax revenues)

Tonnage Tax
For Shipping Industry

Lump sum tax credit
adjustment

Reduction of cantonal corporate tax rates

Reduction of current tax burden to increase attractiveness of Switzerland as a location

Abolition of capital issuance tax

Improvement of participation relief
Direct exemption
Parameters
- *Outside of assessment base*
- *Amortization/impairments no longer tax deductible*
- *Minimum participation requirement abolished*
- *Advantages*
  - *Full direct exemption*
  - *Aligned with international systems*
  - *Administrative/finance expenses no longer have to be calculated and deducted*
  - *Easier from an administrative standpoint*
- *Accompanying measures*
  - *Final losses at the level of subsidiaries might be tax deductible at the level of the Swiss parent*
  - *7 year limitation for loss carry forwards would be eliminated*

Reduction of annual net wealth tax
Reduction for certain assets (IP, loans, participations) among others to compensate for higher book equity due to release of hidden reserves

Step up in case of immigration into an ordinary Swiss tax regime
- *Step up to FMV*

Withholding tax
Withholding tax levied by payment agent

Tax policy measures – new regimes for mobile income

Interest adjusted income tax / notional interest deduction (NID)

Status quo

- ETR applicable to foreign interest income for holding company 7.8%, mixed company 8-10% and finance branch / company structure 0.5-2%.

Facts

- Owing to the abolition of above regimes, interest income would be taxed ordinarily.
- NID, an internationally accepted and widely practiced concept (e.g. FL, B, I), refers to a deduction of interest on qualifying equity in addition to actual interest expenses arising from debt financing. The measure aims to eliminate tax discrimination between debt and equity.
- No booking entry in the accounts required; NID reduces the tax base in the tax return.
- NID is applicable to all entities and thus – depending on the design – would lead to a significant loss in tax revenues. Basically three models are under discussion:

Models under discussion		
Base Model [determining NID on total equity]	**Thin Capitalisation Model** [determining NID on predetermined ratios as per Circular 6]	**Surplus Model** [same as thin cap. model, but more restrictive]

- **Although the NID concept was rejected by the vast majority of Cantons according to the consultation report, we are of the opinion that the NID concept is not yet off the table.**
- **If adopted, the trend goes towards the Surplus Model primarily to limit the loss in tax revenues.**

Tax policy measures – new regimes for mobile income

Interest adjusted income tax / notional interest deduction (NID)

Finance Branch vs. potential NID concepts

Assets (in CHFk)		Liabilities (in CHFk)	
100	Cash	-	Debt
900	IC-loans	1'000	Equity
1'000	**Assets**	**1'000**	**Liabilities**

	Base Model: NID on total equity	Thin Cap. Model: NID based on Circular no 6		Surplus Model: NID on surplus equity		Rejection of NID measure
Cash		0	0%	10	10%	
IC-loans		135	15%	225	25%	
		135		235		
Base for NID Deduction	**1'000**	**865**		**765**		**0**

	Finance Branch				
	in CHFk	in CHFk	in CHFk	in CHFk	in CHFk
Interest income	45.0	45.0	45.0	45.0	45.0
= Basis for notional interest calculation	**45.0**	**45.0**	**45.0**	**45.0**	**45.0**
./.NID up to CHF 1 billion for SFB - Formula (45 / 1.21)	-37.2	-	-	-	-
./. NID according to CTR III - NID rate: 4%	-	-40	-34.6	-30.6	0
Income before taxes	*7.8*	5	10.4	14.4	45
combined ETR (for mixed Co. / 10% Quota): 8.27%	**-0.6**	-	-	-	-
combined ETR: 12%	**-**	**-0.6**	**-1.2**	**-1.7**	**-5.4**
Taxable income	*7.2*	4.4	9.2	12.7	39.6
ETR	**1.44%**	**1.33%**	**2.77%**	**3.84%**	**12.00%**

Tax policy measures – new regimes for mobile income

License Box

Status quo

- ETR applicable to foreign license income for mixed companies is 8-10% (Nidwalden solution: 8.9%)

Facts

- The licence box raises in particular the following **five questions** that need to be addressed:

1) Qualification of IP rights
- Broad vs.
- Narrow IP definition

2) Entry Test
- No requirements vs.
- Substance requirements vs.
- Relief dependent on activity performed in CH

3) Calculation method
- Direct method vs.
- Indirect method

[Both to be supported by Transfer Pricing studies]

4) Relief
- Amount of relief granted on qualifying IP income
- Relief on CCT level vs. DFT level

5) Transitional Rule
- Governing e.g. the change from ordinary or privileged taxation to a license box regime (step-up etc.)

1. Qualification of IP rights

- **Narrow definition:** limited to patents only
- **Broad definition:** inclusive other IP, like marketing IP, Trademark, IP component embedded in products/services

The current trend is moving towards a narrow application as the broader the regime the higher loss in tax revenue

2. Entry Test

- **Super-Box**: Attractive, risk that letter box companies benefit from regime (**no test**; not conforming to BEPS)
- **Medium-Box:** Meeting certain substance requirements: control over research / development / innovation / protection out of Switzerland with respective substance **(substance test)**
- **Restrictive-Box:** Research / development / innovation activities to be performed in Switzerland **(activity test)**

Policymakers can start from the Nidwalden solution applying a substance test and move to a more restrictive box should this be required by guidelines from the EU, or the OECD on grounds of BEPS.

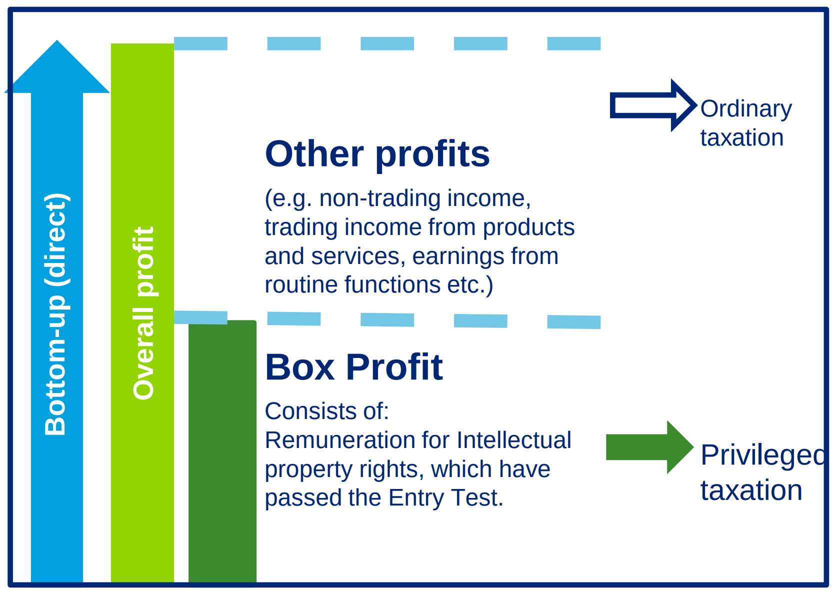
Tax policy measures – new regimes for mobile income

License Box

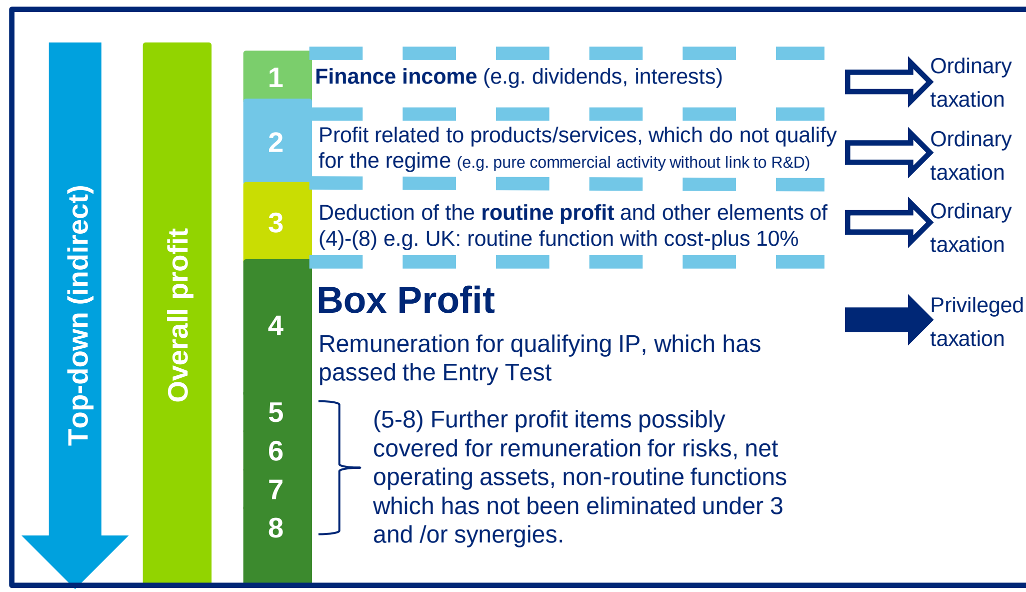
3. Calculation method

The relevant profit is the portion of the overall profit that benefits from the regime / special tax rate, as depicted below:

(i) **direct method**



(ii) **indirect method**



- **Bottom up** approach (or net license approach)
- "Transfer Pricing heavy" and thus **not** preferred

- **Top down** approach
- **Simpler and thus the preferred method!**

Tax policy measures – new regimes for mobile income

License Box

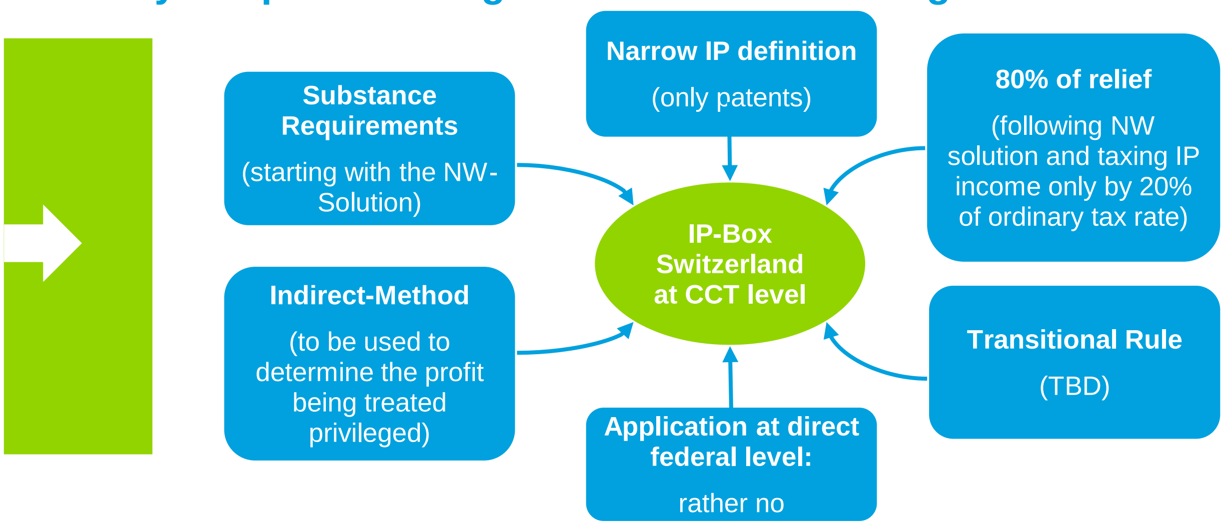
4. Tax reduction

- The extent of the tax reduction is in the discretion of the cantonal legislature.
- E.g. Nidwalden solution: taxes only 20% of qualified IP income at the ordinary tax rate (ETR approx. 8.9%)
- **Will the federation introduce an IP Box a the federal level? ➔ … we consider the odds to be rather low.**

5. Transitional rule

- **Rule 1:** **Existing and future IP would qualify irrespective of the current tax status**
  [Would be the most attractive rule, but would cause the highest loss in tax revenues]
- **Rule 2:** **Only apply the regime to IP that was created during a specific predetermined period**
  [Such approach was e.g. applied for the capital contribution principle]
- **Rule 3:** **Change from an ordinary regime to a privileged license box regime**
  [Taxing the hidden reserves that were transferred from an ordinary to a license box regime]

6. Summary - Expected design of the license box regime



Tax policy measures – reduction of current tax burden

Step-up in basis in case of immigration into CH or status change

Status Quo / Facts

In general

- The determination of taxable income is based on the principle that "tax follows book" (Massgeblichkeitsprinzip); exceptions basically need to be explicitly provided by law.

Step-up in case of immigration into Switzerland

- The government acknowledges that the current law explicitly rules the emigration from Switzerland, but lacks rules on immigration into Switzerland.
- The interim report states that for purposes of planning reliability it would be justified to legally govern also the event of immigration into Switzerland and that the tax authorities should rely on a fair market valuation.
- The interim report is silent as to the possibility of a step up of self-created goodwill, most likely for tactical reasons.

Step-up in basis for status change

- The step-up at the time of a status change from a privileged tax regime to an ordinary tax regime is already an established practice and confirmed by the Federal Supreme Court in its judgments dated March 12, 2012 (2C_645/2011) and February 18, 2014 (2C_842/2013) both referring to holding entities.
- There is reference to a step-up in relation to companies that benefit from a principal company regime for federal tax purposes (DFT).
- Preparation of a statutory balance sheet for DFT and a tax balance sheet for cantonal/communal tax (CCT) purposes which inter alia differ as to hidden-reserves disclosed for CCT purposes and underlying depreciation.

Tax policy measures – reduction of current tax burden

Step-up in basis in case of immigration into CH and status change

Illustration: Solution of Swiss Federal Tax Administration (SFTA) vs. Grandfathering solution

Assumptions:
- no future profit increase
- amortization period: 10 years
- current tax exemption at CCT level: 80%
- step-up 100 (profit of 10 capitalized with factor 10)
- combined ETR 20% (FT: 7.8% / CCT 12.2%)

SFTA solution

Year		0	1	2	3	4	5	6	7	8	9	10	11ff
Op. Profit		10	10	10	10	10	10	10	10	10	10	10	10
step-up / amort.		100	-10	-10	-10	-10	-10	-10	-10	-10	-10	-10	0
FT Base		10	10	10	10	10	10	10	10	10	10	10	10
CCT Base		22	0	0	0	0	0	0	0	0	0	0	10
FT	a	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783
CCT	b	2.684	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.22
deferred tax payment	c	-2.44	0.244	0.244	0.244	0.244	0.244	0.244	0.244	0.244	0.244	0.244	0
Total Tax	a+b+c	1.027	1.027	1.027	1.027	1.027	1.027	1.027	1.027	1.027	1.027	1.027	2.003
ETR		10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	10.27%	20.03%

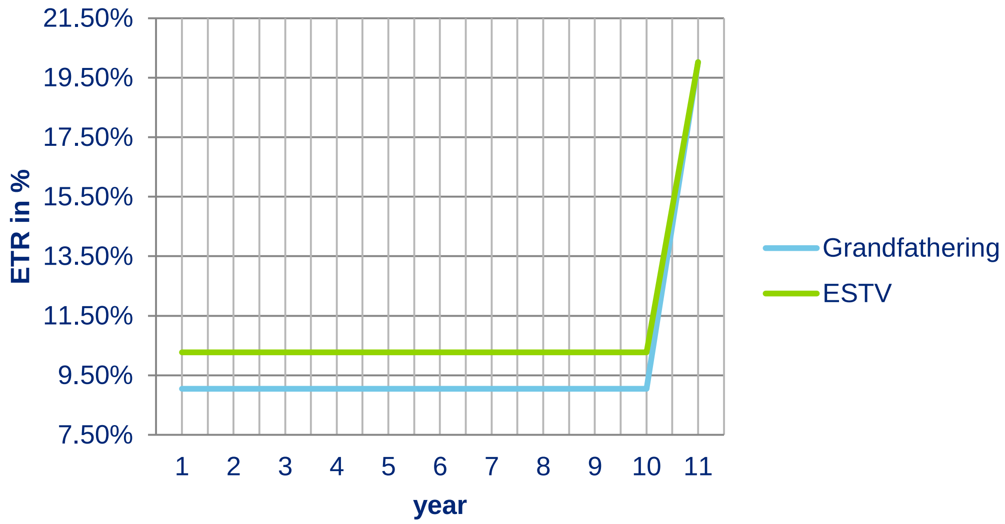
Grandfathering solution – preferred by industry

Year		0	1	2	3	4	5	6	7	8	9	10	11ff
Op. Profit		10	10	10	10	10	10	10	10	10	10	10	10
step-up / amort.		0	-9	-9	-9	-9	-9	-9	-9	-9	-9	-9	0
FT Base		10	10	10	10	10	10	10	10	10	10	10	10
CCT Base		2	1	1	1	1	1	1	1	1	1	1	10
FT	a	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783	0.783
CCT	b	0.244	0.122	0.122	0.122	0.122	0.122	0.122	0.122	0.122	0.122	0.122	1.22
Total Tax	a+b	1.027	0.905	0.905	0.905	0.905	0.905	0.905	0.905	0.905	0.905	0.905	2.003
ETR		10.27%	9.05%	9.05%	9.05%	9.05%	9.05%	9.05%	9.05%	9.05%	9.05%	9.05%	20.03%

Tax policy measures – Reduction of current tax burden

Step-up in basis in case of immigration into Switzerland and status change

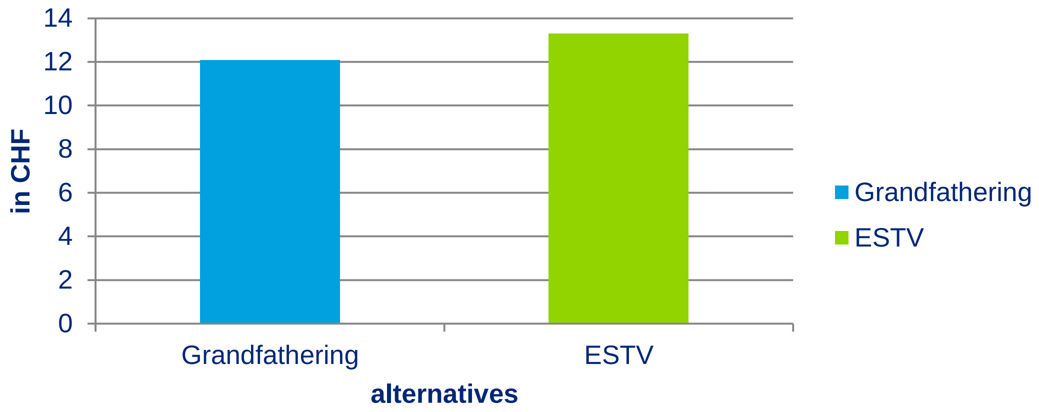
Illustration: SFTA solution vs. Grandfathering solution



Outlook

- **The step-up concept aims to allow multinationals currently benefitting from a privileged regime to retain their low ETR post implementation for an extended period of time** (approx. 10 years) so that these companies can be retained, considering that 10 years is a long time in the world of international tax planning.

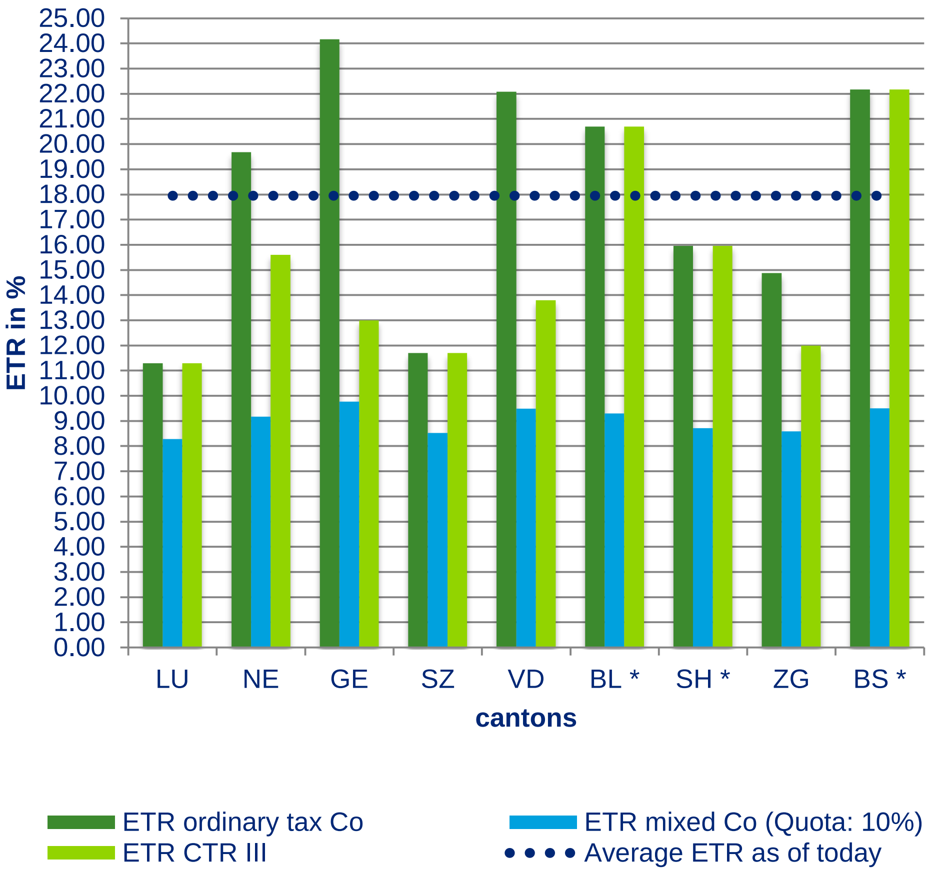
Total income tax burden from year 0 to year 11



Tax policy measures

Reduction of cantonal and communal corporate tax rates

Expected change of ETR of Cantons mainly affected by CT-Reform III



* strategy not clear yet or not officially communicated

- Cantons are basically free to decrease the CCT rates within the boundaries of their budget. The chart demonstrates how the ETR is expected to change on grounds of CTR III.

- In addition, the below Cantons expect to maintain their low headline tax rates which are:

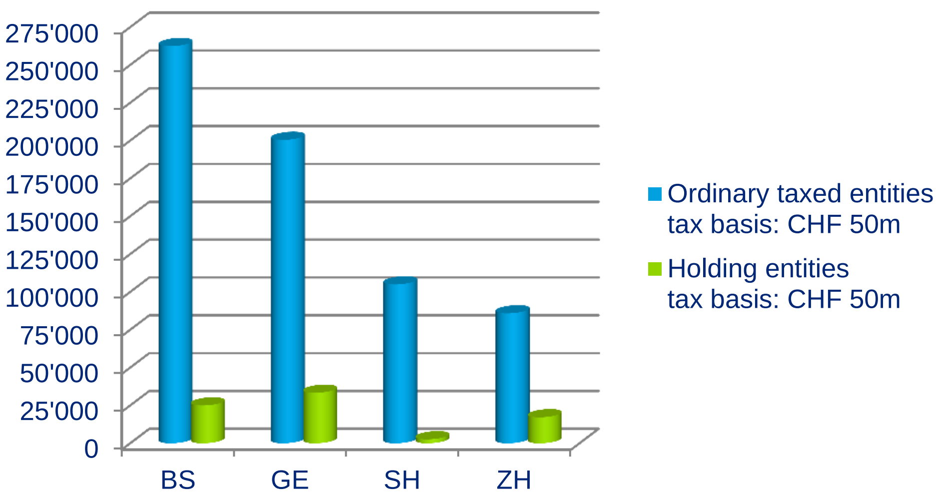
	ETR
▪ Canton AI	14.3%
▪ Canton AR	12.7%
▪ Canton NW/OW	12.7%
▪ Canton Lucerne	11.2%

- Not all Cantons are equally affected by the abolishment of privileged tax regimes. Cantons with high CCT rates which do not follow the above trend, however, run a high risk of mobile income being shifted to more competitive Cantons or even abroad.

- Reducing the ETR below 10% may cause political pressure.

Tax policy measures – Reduction of current tax burden

Reduction of capital tax



At risk

- If capital tax rates are not recued, this may lead to a significant increase of the annual tax burden for currently privileged companies, in particular holding entities (cf. chart)
- Such an additional tax burden may prompt some companies to leave Switzerland.

Status quo

- Several cantons already allow to credit capital taxes against corporate income taxes and thus often eliminate capital taxes altogether.
- **Measures discussed** by the interim report:
  - Complete abolition or at least significant reduction of capital tax, or;
  - Preferential treatment of certain assets such as participations, IP or IC loans for capital tax purposes.
- 10 cantons do not support changes as to capital tax; while 9 cantons and economiesuisse are clearly in favor of such measures and suggest to do further research on the topic.

Tax policy measures – Reduction of current tax burden
Improvement of participation relief

Status quo

- The current concept of participation relief provides for an indirect abatement mechanism as opposed to a direct exemption.
- The current system has proved to be detrimental in situations (i) where a company is highly leveraged and for that reason does not get full relief on qualifying income and (ii) where qualifying income in combination with loss carry does not lead to a participation relief.

Facts

New proposed concept for the participation relief	Additional proposed combined measures
• Income from participations should be excluded from taxable income (change from an indirect to a direct exemption system) • Impairments / depreciation of participations are no longer relevant for tax purposes • Finance and administrative expenses must no longer be taken into consideration ➔ as always full participation relief • No minimum holding percentage required to benefit from the participation relief • Elimination of the disadvantages of the current system	• Final tax losses of subsidiaries can be offset at the level of the parent company (group taxation). • Abolition of the 7 year tax loss carry forward expiration period.

The change in the participation relief is not believed to significantly increase tax attractiveness of Switzerland and is therefore currently a low priority.

Other measures to retain CH tax competitive

low priority

A Abolition of stamp issuance tax

- Currently 1% on the amount of equity contributions into a Swiss company (exemption on the first CHF 1 million nominal share capital)
- Since abolishing this tax would lead to a substantial loss of tax revenues without significantly increasing tax attractiveness of Switzerland (the tax can be avoided in most cases by planning anyhow) it is given a low priority.

B Introduction of Tonnage Tax system

- New tax on profits from companies engaged in maritime transport (privileged taxation of various shipping activities). The amount of the tax depends on the weight of the transported goods.
- Replaces the ordinary corporate income tax for such companies.

C Improvement of tax credit system

- The current tax credit system is relatively complicated. The current system should be replaced by a more practical and competitive tax credit system.

D Implementation of a paying agent system for WHT purposes (outside of CTR III)

- The paying agent levies the tax instead of the debtor with regard to debt instruments (e.g. bonds). No change expected as to securing taxation of income on Swiss shares and hence retaining the debtor principle for Swiss shares.
- The paying agent concept treats specific investor groups based in treaty states more beneficial and provides them with a relief at source.

Tax policy measures – Reduction of current tax burden

Counter financing measures

Facts

Key proposal suggested to compensate for the loss of tax revenues are as follows:

A) Personal income tax on capital gains on sale of securities

- Capital gains on the sale of securities would be subject to personal income tax. Losses on the sale of securities would be tax deductible, however could only be offset with capital gains of securities.
- Approx. CHF 300m additional annual DFT revenue and CHF 700m additional annual CCT revenue
- The majority of Cantons supports further research on the topic.

B) Increase of VAT rate

- Compared the EU, Switzerland has very low VAT rates.
- Most cantons are not in favor of an increase in VAT rate for political reasons (as it would be difficult to sell to the Swiss voter).

C) Broadening of taxable income

- Abolition of certain tax deductions (e.g. meals & entertainment expenses).
- More tax audits at DFT level.
- Most cantons are not in favor of increasing the tax burden for individuals.

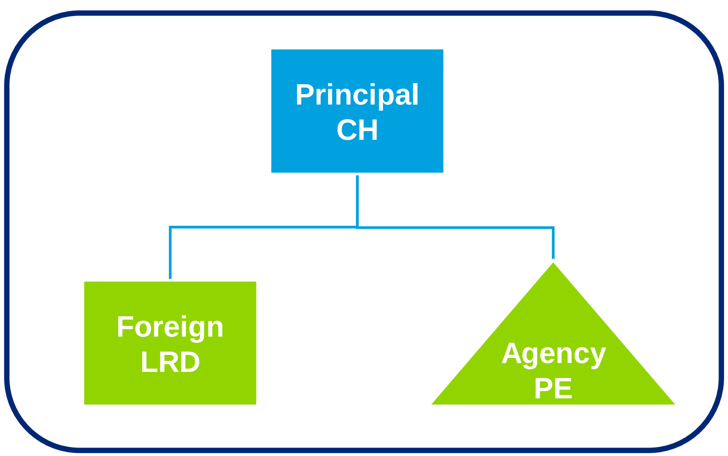
An increase in taxation of individuals to compensate for a loss in corporate tax revenues due to CTR III is unpopular and may not pass a popular vote.

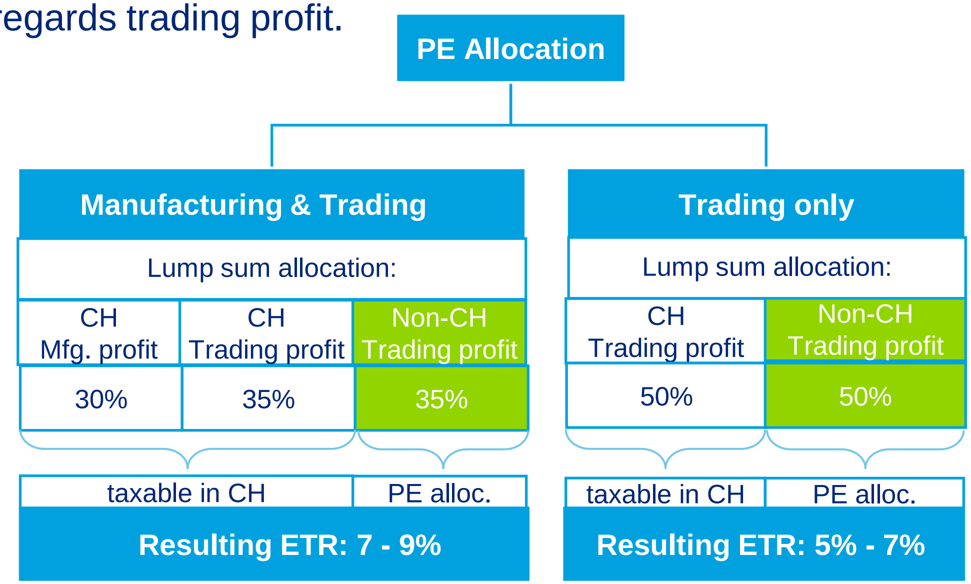
Principal Company Regime
Tightened guidelines in interpreting Circular 8

Principal Company Regime

old interpretation of Circular No 8

- Typical features of distributors under a principal regime:
  - Distribution companies must have the function of an agent entitled to conclude contracts (commissionaire or LRD).
  - Minimum consideration since a routine function is performed.
- As commissionaires / LRDs, these entities qualify as a PE of the Principal according to art. 5 para. 5 of the OECD Model Treaty and part of the profit has to be allocated to that deemed foreign PE, which in reality often is not taxed in the foreign jurisdiction.
- Hence, income not being taxed by the foreign jurisdiction results in a reduction of the ETR at Principal level.
- Regime is under criticism for including ring fencing elements, in particular because of the 50% lump sum profit allocation to the deemed PE, as regards trading profit.





Principal Company Regime

new interpretation of Circular No 8

1. **Exclusivity-Test of commissionaires / LRDs vis-à-vis Principal**
   - Distribution companies only allowed to perform distribution function for Principal
   - At least **90%** of the profit must be from respecting trading activity for Principal

At risk: Denial of deemed PE allocation to LRD's not satisfying the exclusivity-test.

2. **Minimal Margin-Test at level of commissionaires / LRDs**

SFTA limits the acceptable gross profit margin for commissionaires / LRDs at 3% (or higher costs)

At risk: Distributors accounting for a higher gross margin lead to a reduction of the profit attributable to the foreign deemed PE (even if in line with the dealing at arm's length principle)

3. **Outsourcing of Principal Functions**

At risk: Outsourcing of principal functions to foreign companies results in an adjustment of the principal allocation (reduction of profit being attributed to the foreign PE)

4. **MAPs / APAs**

APAs / MAPs earlier resulted in a denial of corresponding adjustment (unpublished FTA practice). Under the new practice, APAs / MAPs have no impact on principal allocation as such.

Implication on ETR: Increase of ETR to max. 8-10% (depending on the Canton)