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Newsletter

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TAX

The End of Swiss Tax Privileges for Holdings, Finance Branches, Principal and Mixed Companies

This newsletter describes the internationally accepted yet competitive implementation of the agreement with the European Union regarding the end of the above mentioned Swiss tax privileges. The newsletter also demonstrates how Switzerland will implement Action 5 of the OECD's BEPS Action Plan regarding harmful tax practices.

1 INTRODUCTION

For more than ten years, the **tax privileges** for holding companies, administrative companies and mixed companies on a cantonal level as well as the taxation of principal companies and the Swiss Finance Branch structures on federal level have been **under international pressure**.

In October 2014, this pressure led to the signing of a joint statement on business taxation and **the end of the tax dispute with the European Union**. Furthermore, it has led to a note in the **OECD's deliverable on Action 5 of the BEPS Action Plan, regarding countering of harmful tax practices**, where Switzerland is stated as abolishing these privileges. Switzerland intends to replace these privileges as part of its **corporate tax reform III** per the end of 2018 or 2019 (see also our recent newsletter of July 2014).

2 AFFECTED STRUCTURES AND OPTIONS

2.1 GENERAL REMARKS

Companies which benefit from a tax privilege today must consider **alternative structuring** in Switzerland. The corporate tax reform III offers various options to keep the effective tax burden attractive.

In the following you will find a description of these options, which are broken down based on the various privileges. First, the activity of such privileged company is described. Then, today's and tomorrow's possible taxation of such activity from a Swiss tax point of view is outlined. One option for all privileged companies - irrespective of the corporate tax reform III - is to move the activity to a low tax canton (some cantons have already lowered their corporate income tax rates and other cantons will follow).

2.2 PURE HOLDING COMPANY

Activity: A pure holding company holds and manages qualifying participations in and outside of Switzerland. Such company does not have any business activity involving third parties. Hence it receives mainly dividend income and realises capital gains from investments.

"Companies with a tax privilege must consider alternative structuring in Switzerland."

Today's taxation on a cantonal level: Under the cantonal holding privilege such company does not pay any corporate income tax and only a reduced capital tax.

Today's taxation on a federal level: Based on the participation exemption according to Article 69 of the Federal Income Tax Act (FITA), a holding company is taxed marginally or not at all.

Future taxation on a cantonal level: A holding company will become a company subject to ordinary statutory taxation. The possibility of a participation exemption on qualifying dividend income and capital gains will, however, remain the same. In addition, the corporate tax reform III proposes a change from an indirect to a direct exemption of participation income, including the extension to portfolio investments without a holding period requirement. This means that participation income and capital gains will be entirely exempt from taxation. As a result of the fact that the pure holding company generates its income mainly from investments, an exemption of such income results in non-taxation of these profits. The cantons will likely also provide for a **reduced tax on equity**.

Future taxation on a federal level: The taxation will be the same as on the cantonal level, which means that, on the federal level as well, a participation exemption applies.

Overall taxation after 2018/2019: Capital gains and dividends of a pure holding will continue to be taxed marginally or not at all. This means that Switzerland remains an attractive holding jurisdiction.

2.3 MIXED COMPANIES WHICH USE IP RIGHTS

Activity: A mixed company can make use of IP rights outside of Switzerland and, to a limited extent, also in Switzerland. An example is a software company predominantly selling software in other countries.

Today's taxation on a cantonal level: Under mixed company tax privilege, foreign revenues are taxed only at a reduced rate. In addition, in most cantons a reduced capital tax is due.

Today's taxation on a federal level: A mixed company is subject to ordinary taxation on a federal level. This results in an effective tax rate for foreign source income of 9% to 13% at a federal and cantonal level today.

Future taxation on a cantonal level: Such company will, in the future, be subject to ordinary taxation. As a first option the company **can relocate its activity to a low tax canton** to benefit from lower income tax rates (approximately 10% to 14%). A second option is the so-called **Intellectual Property-Box** (**IP-Box**), which shall allow a reduced taxation of income from immovable property rights. It must be assumed that the IP-Box will be similar to the IP-Box in the sense of the Germany-UK Joint Statement issued on 14 November 2014. The countries agreed to a so called **modified nexus approach** under which privileged taxation is accepted if substantial local activity exists. Furthermore, certain income realized from activities outside of the jurisdiction qualifies for taxation under the IP-Box rules.

"The IP-Box is an option for companies that use IP rights"

Step-up during transition period: Before transitioning into the regime of ordinary taxation, a mixed company can step up its tax values to the fair market value (without any step-up in the commercial accounts), provided such values have been generated while the privileged taxation regime applied (see our newsletter of July 2014). Such stepped-up values can be tax effectively written down in the following periods. Such depreciation potentially reduces the taxable profit and hence the tax burden. The step-up must be assessed on a case-by-case basis and very much depends on the hidden values.

Future taxation on a federal level: The taxation on federal level remains unchanged on.

Overall taxation after 2018/2019: Income from IP rights will probably continue to be taxed at an effective tax rate of 8% to 14% depending on the canton and activity.

2.4 MIXED COMPANIES WITH A PURE TRADING ACTIVITY

Activity: A mixed company with a pure trading activity sells goods predominately outside of Switzerland.

Today's taxation on a cantonal level: Under mixed company privilege, foreign source income is taxed at a reduced rate. In addition, most cantons levy only a reduced equity tax.

Today's taxation on a federal level: A mixed company is subject to ordinary taxation which results in an overall corporate income tax rate of 9% to 14%.

Future taxation on a cantonal level: The corporate tax reform III and the cantonal tax laws will provide for a **general reduction of the tax rate** for companies of this kind.

"Income from immovable / intellectual property will be taxed at a rate of 8% to 14% in the future depending on the canton and activity."

Step-up during transition period: Before transitioning into the regime of ordinary taxation, a mixed company can step up its tax values to the fair market value (without any step-up in the commercial accounts), provided such values have been generated while the privileged taxation regime

applied (see our newsletter of July 2014). Such stepped up values can be tax effectively written down in the following periods. Such depreciation potentially reduces the taxable profit and hence the tax burden. The step-up must be assessed on a case-by-case basis and very much depends on the hidden values.

Future taxation on a federal level: The taxation does not change and will be the same as on a cantonal level.

Overall taxation after 2018/2019: Trading income will be taxed at an overall effective tax rate of 10% to 14% in the future.

2.5 PRINCIPAL COMPANIES

Activity: Principal companies are companies with central functions, responsibilities and risks concentrated in one entity. The distribution of products is in general done via a commissioner or agent. The production on the other side is conducted in the name and on behalf of the principal company through third parties or group companies. Often, a principal company also manages IP rights and licenses such rights to group entities.

Today's taxation on a cantonal level: Such principal companies benefit from taxation as mixed companies (in this respect see above 2.3).

Today's taxation on a federal level: At least 50% of the trading activity will be allocated to the principal company for the assumption of functions and risks and taxed at the ordinary rate. Furthermore, if such a principal company is also involved in production, 65% of its profits are taxed in Switzerland. Such allocation is done unilaterally. As a result, one sees an effective tax rate for such activity of about 5% today.

Future taxation on a cantonal level: Reference can be made here to the above explanations regarding mixed companies. In particular, the IP-Box and/or in a transition period the step-up and depreciation of hidden values can be tax optimizations. Furthermore, principal companies do need to consider whether they want to relocate their activities to a canton with a low ordinary tax rate.

Future taxation on a federal level: A principal company will be taxed as an ordinary company in the future. Currently, it is unclear whether a step-up and depreciation will be granted on a federal level a well for a transition period.

Overall taxation after 2018/2019: As a result of the introduction of the IP-Box certain income on the intellectual property rights can be taxed at a reduced rate. Principal companies will, therefore, likely be taxed at an effective tax rate of 8% to 14% depending on the canton and activity.

2.6 SWISS FINANCE BRANCH

Activity: A Swiss Finance Branch is a branch of a foreign company with a finance function for the group. The branch receives funding from headquarters for the financing of group companies.

Today's taxation on a cantonal level: Such Swiss Finance Branch benefits from mixed company tax privilege as well as a deemed interest deduction for the capital that is provided for the finance activity.

Taxation on federal level: A Swiss Finance Branch benefits from the same deemed interest deduction. As a result, overall effective tax rate of approximately 2% to 3% can be observed today.

Future taxation on a cantonal level: As a result of the transition of a Swiss Finance Branch into a Swiss branch subject to ordinary statutory taxation, its interest income will become subject to ordinary taxation in Switzerland. Besides the options mentioned above with regard to mixed companies (relocation of the activity to a low tax canton, potential step-up and depreciation of hidden values during a transition period) the so-called notional interest deduction on equity is an additional benefit (see our newsletter of July 2014 with more details in this respect).

Future taxation on a federal level: A Swiss Finance Branch will be taxed like an ordinary company. A notional interest deduction on equity will apply on a federal level as well.

Overall taxation after 2018/2019: As a result of the increased interest deduction rights, the overall profit and also tax burden is reduced. This additional reduction must be assessed on a case-by-case basis, as it very much depends on the equity and the applicable interest rates.

"Switzerland offers a competitive corporate income taxation since many years."

3 OUTLOOK

It is undisputed that the implementation of the memorandum of understanding with the European Union fundamentally changes the taxation framework in Switzerland. As a result of the development within the European Union (for instance cases regarding state aid procedures) and also as a result of the BEPS Project supported by Switzerland, all countries will see fundamental changes in order to ensure that companies pay their fair share of taxes.

Tax structures involving Swiss companies will only be accepted on an international level provided they fulfill the **international substance and transparency requirements**. This will require such structures to have qualified employees as well as offices and to disclose this to foreign tax authorities. This is, however, without doubt possible in Switzerland and Switzerland will hence remain attractive.

Switzerland since many years offers **competitive income taxation** and this should remain the case also in the future.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please contact your Schellenberg Wittmer liaison or any of the following persons:

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