Tax Proposal 17

Swiss Federal Council released Tax Proposal 17 for formal consultation

Welcome to our webinar!

28 September 2017
Your presenters today

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Partner, Tax Services Switzerland
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Tax Proposal 17 (TP 17)

- Negative popular vote on 12 February 2017 for Corporate Tax Reform III (CTR III); rejection by 59.1% of voters
- New Tax Proposal 17 was immediately initiated by Swiss Federal Council
- Consultation draft now issued on 6 September 2017 (within record time)
- Draft contains many adjustments to original CTR III proposal
# Overview of the TP 17 measures

## Tax Proposal 17 in a nutshell

### Mandatory cantonal Patent Box according to OECD-standard

- Increase of partial taxation of private dividend income
  - Federation: 70%
  - Cantons min. 70%

### Optional cantonal R&D super-deduction (max. 50%)

- Increase of cantonal share in direct federal tax revenues from 17% to 20.5%

### Current cantonal step-up practice and tax effective depreciation of hidden reserves (max. 10 years; DTA)

- Basis: Legal certainty & investment security

### Separate taxation of formerly tax free hidden reserves (during 5 year transition period)

- Increase of cantonal share in direct federal tax revenues from 17% to 20.5%

### Adaption of cantonal capital tax base for participations and patents

- Increase of cantonal share in direct federal tax revenues from 17% to 20.5%

### Increase of children and education allowances by CHF 30

### Maximum limitation of reliefs of max. 70%

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### No longer included:

- NID

### Deferred:

- Abolition of issuance stamp tax

## Basis: Legal certainty & investment security

## Cantonal rate reductions
Cantonal Patent Box and R&D input promotion

Abolition of tax regimes (holding, mixed, domiciliary, principal and finance branch regimes)

- Mandatory cantonal Patent Box according to OECD-standard
  - Current cantonal step-up practice and tax effective depreciation of hidden reserves (max. 10 years; DTA)
- Optional cantonal R&D super-deduction (max. 50%)
  - Separate taxation of formerly tax free hidden reserves (during 5 year transition period)
- Adaption of cantonal capital tax base for participations and patents
- Increase of partial taxation of private dividend income
  - Federation: 70% Cantons min. 70%
- Increase of cantonal share in direct federal tax revenues from 17% to 20.5%
- Increase of children and education allowances by CHF 30

No longer included: NID
Deferred: Abolition of issuance stamp tax

Basis: Legal certainty & investment security
Overview

Patent Box

R&D incentive

Key messages
Source of information

Bundesgesetz über die Steuervorlage 17 (SV17)

vom ...

Particularly relevant

Art. 24a Patent Box
Art. 24b Patent Box
Art. 25a R&D incentive
Art. 25b Limitation of tax deduction

Particularly relevant

Art. 1.2.2 and 1.2.3 (pages 9–11)
Art. 2.3 (pages 24–25)
Art. 2.7 (pages 30–34)
Overview

Innovation
Tax incentives

Output support
‘Patent Box’

Input support
‘R&D&I tax incentive’

Mandatory
Canton

Voluntary
Canton

28 September 2017
PwC
Patent Box

R&D incentive

Key messages
Patent Box – Tax harmonisation law

Qualifying intellectual property

- **Patents:** (i) EPC; (ii) CH PatG; (iii) foreign patents which are equivalent to EPC and PatG
- **Equivalent rights:** (i) protection certificates CH PatG; (ii) Topographies CH ToG; (iii) plant protection CH SortenschutzG; (iv) protected documents CH HMG; foreign rights equivalent to (i)–(iv)
- **Not qualifying:** copyrighted Software; not patent protected inventions for SMEs

Substance

- Modified Nexus approach (reference is made to the appendix)

Mechanism (overview)

- Direct approach (license fees, sale of patents and equivalent rights)
- Residual approach (if patents and equivalent rights are embedded in the products)
- Compensation for routine activities (full cost +6%) and trademark
- Buy-in costs — legacy R&D costs of qualifying IP for the last 10 years

Base reduction

- Maximum 90%. Cantons may further reduce the applicable discount.
- Additional Art. 25b — all regimes (Patent Box, R&D super deduction) should not exceed 70% of pre-tax profits (=maximum relief limitation)
**Patent Box Mechanism (profit per qualifying IP; direct approach)**

<table>
<thead>
<tr>
<th></th>
<th>IP A</th>
<th>IP B</th>
<th>Total</th>
<th>Ordinary taxed</th>
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</thead>
<tbody>
<tr>
<td>Gross income from qualifying IP*</td>
<td>100</td>
<td>80</td>
<td>180</td>
<td></td>
</tr>
<tr>
<td>Direct costs related to income from qualifying IP</td>
<td>-10</td>
<td>-5</td>
<td>-15</td>
<td></td>
</tr>
<tr>
<td>Net income from qualifying IP</td>
<td>90</td>
<td>75</td>
<td>165</td>
<td></td>
</tr>
<tr>
<td>Multiplied by Nexus Ratio per qualifying IP</td>
<td>80%</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from qualifying IP</td>
<td>72</td>
<td>75</td>
<td>147</td>
<td></td>
</tr>
<tr>
<td>Multiplied by the maximum reduction as per Canton</td>
<td>90%</td>
<td>90%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from qualifying IP which will not be taxed</td>
<td>64.8</td>
<td>67.5</td>
<td>132.3</td>
<td></td>
</tr>
</tbody>
</table>

* Reduced by finance income/expenses; participation income and other, none qualifying IP related income
### Patent Box Mechanism (profit per **Product; residual approach**) I/II

<table>
<thead>
<tr>
<th></th>
<th>Product A</th>
<th>Product B</th>
<th>Total</th>
<th>Ordinary taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income per product with qualifying IP</td>
<td>1,000</td>
<td>600</td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td>Full cost of production</td>
<td>800</td>
<td>450</td>
<td>1,250</td>
<td></td>
</tr>
<tr>
<td>Net income per product</td>
<td>200</td>
<td>150</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>6% on full cost of products</td>
<td>-48</td>
<td>-27</td>
<td>-75</td>
<td>75</td>
</tr>
<tr>
<td>Trademark income (e.g. 1%)</td>
<td>-10</td>
<td>-6</td>
<td>-16</td>
<td>16</td>
</tr>
<tr>
<td>Patent Box profit before Nexus Ratio and maximum reduction</td>
<td>142</td>
<td>117</td>
<td>259</td>
<td></td>
</tr>
</tbody>
</table>
### Patent Box Mechanism II (profit per Product; residual approach) II/II

<table>
<thead>
<tr>
<th></th>
<th>Product A</th>
<th>Product B</th>
<th>Total</th>
<th>Ordinary taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patent Box profit before Nexus Ratio and maximum reduction</td>
<td>142</td>
<td>117</td>
<td>259</td>
<td></td>
</tr>
<tr>
<td>Multiplied by Nexus Ratio per qualifying IP</td>
<td>80%</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income per product</td>
<td>113.6</td>
<td>117</td>
<td>230.6</td>
<td>(259–230.6) 28.4</td>
</tr>
<tr>
<td>Multiplied by the maximum reduction as per Canton</td>
<td>90%</td>
<td>90%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income from products with qualifying IP which will not be taxed</td>
<td>102.24</td>
<td>105.3</td>
<td>207.54</td>
<td>(230.6–207.54) 23.06</td>
</tr>
</tbody>
</table>
### Patent Box Mechanism II (profit per Company; residual approach)

<table>
<thead>
<tr>
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<th>Product A</th>
<th>Product B</th>
<th>Total</th>
<th>Ordinary taxed</th>
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<tbody>
<tr>
<td>Company net taxable profit</td>
<td></td>
<td></td>
<td>400</td>
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<tr>
<td>Finance income/expenses,</td>
<td></td>
<td></td>
<td>-50</td>
<td></td>
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<tr>
<td>participation income and</td>
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<tr>
<td>other, none qualifying IP</td>
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<tr>
<td>related income</td>
<td></td>
<td></td>
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<tr>
<td>Quota per Product</td>
<td>65%</td>
<td>35%</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Net income per product with</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>qualifying IP</td>
<td>(350 x 65%)</td>
<td>(350 x 35%)</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td></td>
<td>227.5</td>
<td>122.5</td>
<td></td>
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<tr>
<td>Same procedure as per product</td>
<td></td>
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<tr>
<td>residual approach (using</td>
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<td>quota)</td>
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**Patent Box ‘the small print section’**

**Timing**
- **Entry:** In the year when the qualifying IP rights are granted
- **Exit:** In the year when the underlying qualifying IP expires
- **Revocation of qualifying IP:** no Patent Box benefits anymore in and as of the year of revocation; no tax adjustments for prior years

**Losses**
- ‘real’ and ‘artificial’ losses
- ‘real’ losses — Patent Box will be applied on a consolidated level
- Case 1: ‘real’ loss -> box tax loss carry forward
- Case 2: ‘artificial’ loss because of trademark income -> no box tax loss carry forward
- Case 3: ‘artificial’ loss because on nexus ratio -> no box tax loss carry forward

**Documentation**
- (i) nexus calculation (R&D costs) and (ii) per qualifying IP/product calculation
- If, for the first application of the Patent Box, the R&D costs can not be appropriately attributed to a qualifying IP or product, then the current year’s and the last 4 years R&D costs in total can be considered to calculate nexus ratio
- As of first application of the Patent Box, R&D costs and net income need to be tracked per IP/product
- If products deviate only marginally, tracking and tracing per product family allowed
- Tax authorities can collect the documentation
R&D incentive

Patent Box

R&D incentive

Key messages
**R&D incentives – Tax harmonisation law**

### Innovation
- Broad definition (scientific research) as per article 2 of the CH innovation law (FIFG)
- (i) basic research; (ii) applied research; (iii) science based innovation

### Cost base
- Own R&D costs (limited to personnel costs; salary + social security costs)
- Uplift of 35% for other R&D related costs
- 80% of domestic contract R&D with 3rd parties

### Mechanism
- Super deduction
- 50%
- If contracting party is eligible to R&D incentive, then contractor does not benefit

### Base reduction
- Additional Art. 25b – all regimes (Patent Box, R&D super deduction, step-up) should not exceed 70% of pre-tax profits before offsetting losses (=maximum relief limitation)
Summary – Next steps

Key messages

Patent Box

R&D incentive
Key messages

Who can benefit from the Patent Box and R&D incentive?
• Companies with patents and equivalent rights
• Companies that have R&D expenses in Switzerland
• All companies, independent of size or industry

What can you start doing right now?
• Assess impact of Patent Box and R&D incentive for your company
• Simulate future effective tax rate under new Patent Box regime
• Discuss R&D strategy within firm to assess how best to qualify and benefit from Patent Box and R&D super deduction
• Apply holistic view - optimize combination of tax proposal 17 measures (step-up, Patent Box, including entry into Patent Box, R&D super deduction, capital tax etc.)
Overview

Abolition of tax regimes (holding, mixed, domiciliary, principal and finance branch regimes)

Tax Proposal 17

Mandatory cantonal Patent Box according to OECD-standard

Optional cantonal R&D super-deduction (max. 50%)

Current cantonal step-up practice and tax effective depreciation of hidden reserves (max. 10 years; DTA)

Separate taxation of formerly tax free hidden reserves (during 5 year transition period)

Adaption of cantonal capital tax base for participations and patents

Increase of partial taxation of private dividend income

Federation: 70%

Cantons min. 70%

Increase of cantonal share in direct federal tax revenues from 17% to 20.5%

Increase of children and education allowances by CHF 30

Maximum limitation of reliefs of max. 70%

Basis: Legal certainty & investment security

Cantonal rate reductions

Deferred:

No longer included:

NID

Abolition of issuance stamp tax

3 Treatment of hidden reserves and goodwill
Treatment of hidden reserves and goodwill
Overview – holistic concept

General provisions:

Entry into Swiss corporate tax liability
→ Step-up of hidden reserves and goodwill, i.e. entry @ FMV
→ New: Art. 61a DBG & Art. 24c StHG

Change of tax residency within Switzerland
→ No taxation of hidden reserves

Exit from Swiss corporate tax liability
→ Exit taxation @ FMV
→ New: Art. 61c DBG & Art. 24d StHG

Special provisions:

Abolition of special cantonal tax regimes
→ Transitional rules according to Art. 78g StHG
→ Supplemented by step-up according to current tax practice

Entry into Patent Box
→ Art. 24b StHG

Exit from Box
→ No explicit rules
Abolition of special cantonal tax regimes
Treatment of previously tax free hidden reserves and goodwill

Special provisions:

- Transitional rules are an essential element for all tax regime companies, in particular if they lack of R&D activities in Switzerland
- Transitional rules will replace the varying current cantonal step-up tax practices
- Temporarily eliminate or limit the immediate increase of tax charge at time of loss of tax regime – otherwise
  - Holding companies from 8% ➔ 12%-21%
  - Mixed and domiciliary companies from 10%-11% ➔ 12%-21%
  - Principal companies from 6.5%-7.5% ➔ 12%-21%
- Reduces and defers the incentive to relocate activities (e.g.) from high tax to low tax cantons, such as Zug or Schaffhausen, which both have announced target ETRs of around 12%.
Abolition of special cantonal tax regimes

2 options

According to current cantonal tax practice (majority of cantons)

Option 1
Tax free step-up in tax balance sheet and subsequent tax effective amortisation

Treatment of previously tax free hidden reserves and goodwill

Option 2
Separate (low) rate taxation during period of five years

According to new draft tax law (mandatory for all cantons, but freedom of cantons to determine applicable tax rate)
Comparison of options
Treatment of previously tax free hidden reserves and goodwill

According to current cantonal tax practice

From now until effectiveness of TP17
→ Tax free step-up with subsequent tax effective amortisation (max. ten years); DTA effect

Maximum relief limitation of 70% (or lower)!


According to new draft tax law

As of effectiveness of TP17
→ five years with separate (low) tax rate; no DTA effect

- How does an optimal transition to ordinary taxation look like given specific facts of your entity?
- How does the interaction between the treatment of hidden reserves and an entry into the Patent Box work given specific facts of your entity?
**Determination of tax free hidden reserves and goodwill – what is the step-up potential?**

**Valuation**

- No given valuation method; but result must be appropriate (e.g. DCF or Swiss 'practitioners method')
- In case of high level of uncertainty concerning the valuation: cantons may request verification of valuation based on actual results; adjustments in favour of / to the disadvantage of tax payer
Yesterday …

… was all about spreadsheets.

Today …

… is all about apps

This is why PwC is proud to introduce the PwC Step-up Calculator. This app was developed jointly by our Swiss Corporate Tax, Valuation and Digital experts. It offers:

A free-of-charge estimation of your company’s step-up potential and

On request, a paid report validated by our Valuation specialists that can be used as a basis for the discussion with the Tax Administration

... at your fingertip, on your desktop or tablet — just like you’re used to with modern web-based applications. But see for yourself: https://stepup.pwc.ch/
## Overview

### Abolition of tax regimes (holding, mixed, domiciliary, principal and finance branch regimes)

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### Tax Proposal 17

| Adaption of cantonal capital tax base for participations and patents |
| Increase of partial taxation of private dividend income |
| Increase of cantonal share in direct federal tax revenues from 17% to 20.5% |
| Increase of children and education allowances by CHF 30 |

### Basis: Legal certainty & investment security
Other measures I/II

Maximum limitation of reliefs
• Reduction of taxable income by Patent Box deduction, R&D deduction and amortisation of step-up according to current cantonal tax practice may not exceed 70% (cantons may define lower limit) (CTR III: 80%)
  ➔ Securing a minimal cantonal corporate taxation of at least 30% (provided no NOLs)

Adaption of cantonal capital tax base
• Cantons may reduce capital tax base relating to participations and patents
  ➔ Compensation for abolition of special cantonal capital tax rate currently applied for regime companies
  ➔ Compared to CTR III, however no relief for equity related to intra-group financing activities

Increase of cantonal share in direct federal tax revenues
• From today 17% to 20.5% (CTR III: 21.2%)
• Compensation for cantons, should allow cantons to improve position in international/inter-cantonal tax (location) competition
  ➔ Will allow cantons to finance ordinary tax rate reductions

Cantonal tax rate reductions
• It is expected that some cantons may significantly lower their ordinary corporate income tax rates to strengthen competitiveness
  ➔ Measure not included in Tax Proposal 17 (fiscal autonomy of the cantons)
  ➔ CTR III: several announcements of ETR-target by various cantons were made
Importance of cantonal tax rate reductions and illustration of possible ETR considering relief limitation
Other measures II/II

**Increase of partial taxation of private dividend income**

- Federation: increase of partial taxation of income from qualifying participations from today 50% (business assets) resp. 60% (private assets) to 70%
- Cantons: must ensure partial taxation of income from qualifying participations of at least 70%, but may tax even higher fraction

→ Results in an increase of income taxation for shareholders in almost all cantons (but counterbalanced by cantonal corporate rate reductions)

**Increase of children and education allowances**

- Increase of minimum children and education allowances by CHF 30 p/mt.
## Overview

**Tax Proposal 17**

### Abolition of tax regimes (holding, mixed, domiciliary, principal and finance branch regimes)

<table>
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<tr>
<th>Proposal</th>
<th>Details</th>
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<td>Deferred: Abolition of issuance stamp tax</td>
<td></td>
</tr>
</tbody>
</table>

Basis: Legal certainty & investment security

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**Cantonal rate reductions**

**Maximum limitation of reliefs of max. 70%**
Solution required to avoid relocations abroad and to retain/increase tax revenues

- **Tax Proposal 17 no longer contains NID proposal.**
- Step-up and transitional rules don’t apply easily for Swiss Finance Branches (lack of hidden reserves on financing assets)
- **For e.g. Zurich NID measure is important to retain financing activities after abolition of Holding and Finance Branch regimes** given the big number of group holding and group financing entities there.
- Approx. 40–50 Finance Branches exist in canton of Zurich which perform international group financing activities (approx. CHF 120 billion) with few but highly qualified staff, and who are highly mobile
- Current level of corporate income taxation amounts to 2.5% to 3%; if tax charge will exceed 10% relocations to abroad very likely
- According to survey performed by Zurich Trade Chamber in collaboration with PwC relocations could be avoided, if tax rate not exceeding 10% would be offered. Compared to todays tax charge of 2.5 to 3% this would result in approx. **CHF 250 million additional tax revenue per annum** from these companies in Zurich alone.
- **NID solution called ‘Allowance for secure financing’** should be reintroduced into package at least as optional element **for cantons which need it**, e.g. Zurich.
  - Need for a ‘grandfathering’ for minimum 5 years for existing entities, and
  - Introduction of a ‘Allowance for secure financing’ at least at cantonal level, and
  - Relief for financing positions to determine capital tax base
  - Canton, city of Zurich, and communes of Zurich together with Zurich based business community are in process to align their positions and collectively demand reintroduction of cantonal NID coupled with grandfathering of existing rules.
Timeline/political agenda

- **March 2017**: Meeting of the steering committee, administration and cantons
- **June 2017**: Sounding of political parties, cities, communes, national churches & business associations
- **March 2017**: Legislative consultation process followed by preparation of bill
- **June 2017**: Publication of consultation draft (6 Sept 2017)
- **December 2017**: Release of bill by Swiss Federal Council
- **February 2018**: Final vote of the Parliament
- **June 2017**: Possible referendum
- **2020/2021?**: Cantonal processes and implementation

Key dates:
- **12 February 2017**: Majority of Swiss citizens voted against CTR III
- **12 February 2017**: Majority of Swiss citizens voted against CTR III on 12 February 2017
- **17 June 2017**: Publication of cornerstones of Tax Proposal 17 (June 2017)
- **17 June 2017**: Publication of cornerstones of Tax Proposal 17 (June 2017)
- **17 June 2017**: Parliament debate
- **17 June 2017**: Referendum period
- **12 February 2017**: Effective date
- **17 June 2017**: Final vote of the Parliament
- **17 June 2017**: Public vote (if any)
- **17 June 2017**: Possible referendum
- **17 June 2017**: Cantonal processes and implementation

Additional notes:
- **Spring 2018**: Publication of consultation draft (6 Sept 2017)
- **2020/2021?**: Effective date
- **2020/2021?**: Possible referendum
- **2020/2021?**: Cantonal processes and implementation
Consider early withdrawal of existing tax rulings

- Avoid spontaneous international exchange of tax rulings from 2018, and disclosure in Transfer Pricing documentation from 2016
- Continue to apply articles of the cantonal law respectively SFTA circular directly

Consider benefits of early step-up versus applying transitional rules upon loss of current cantonal tax privilege

- Determine valuation approach for hidden reserves and goodwill to be stepped-up
- Simulate which option concerning treatment of hidden reserves/goodwill (step-up or transitional rule) is more beneficial
- Consider effects on current tax charge versus deferred tax effects according IFRS/US GAAP

Plan for utilisation of Patent Box and R&D super-deduction

- Selection of patents to be included in box, assess benefits applying nexus formula
- Assess combination of entry taxation of previously deducted R&D costs with potential benefits from step-up

Revisit future use/benefits of keeping separate holding and mixed companies in group structure

- Combine (merge) them to achieve capital tax savings
- Avoiding impact of new overall 70% limitation of reliefs

Substance bundling in the right location

- Bundling of substance to maximize justification of profit allocation to Swiss entity/ies (also to defend BEPS challenges)
- Potentially consider advantages of locating activities in different cantons

If you are a privately owned company, determine distribution strategy early

- Assess overall impact of partial dividend taxation, cantonal rate reduction and other measures, including wealth tax effects
- Simulate optimal timing and form of cash extraction from company in advance of effectiveness of reform
Questions?
For any questions please contact your usual PwC contact or the members of the PwC Tax Proposal 17 core team below

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