

TAX EFFICIENT SUPPLY CHAIN MANAGEMENT

TESCM – Hotspot Switzerland

What are the benefits of moving a business
to Switzerland

TAX/ADVISORY

A study by KPMG Switzerland in co-operation with the Institute for Accounting, Controlling and Auditing at the University of St. Gallen and the Chair of Technology and Innovation Management at ETH Zurich

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1 Executive Summary

Tax Efficient Supply Chain Management (TESCM) helps multinational corporations reengineer their value chain, control the complexity of their businesses and gain significant financial benefits from a superior business model. It involves shifting key value-adding activities, functions and risks to a centralized supply chain management company. Choosing an appropriate location for this Principal entity is one key driver of a successful TESCM initiative.

Switzerland provides a variety of non-tax related advantages: strategic location in the heart of Europe, high quality of life and well developed infrastructure in addition to an attractive system of taxation. These characteristics traditionally made Switzerland the country of choice for multinational corporations wishing to reorganize their European operations by establishing a centralized Supply Chain Management Company (Principal structure).

This White Paper sheds light on Switzerland's attractiveness as a location for a Principal Company. Our findings derive from an interview study methodology. To reveal best practice trends and to gain real insights from industry professionals, we interviewed multinational corporations that are currently executing TESCM initiatives or have already completed such projects. Interviewees represent various industries and firm sizes from private, family-owned businesses to large listed corporations. In addition to companies currently working on TESCM initiatives, we also interviewed other location stakeholders such as economic promotion agencies, tax authorities and lobbying professionals. The results of these interviews were incorporated into our findings. Due to the sensitivity of the topic and its competitive implications, the identity of interview participants is not disclosed.

Our key findings reveal that the following country features motivate companies to set up their Principal structure in Switzerland:

- Favorable tax environment
- High quality of life
- Efficient infrastructure
- Qualified workforce
- Conducive legal environment
- Variety of opportunities in different cantons

In implementing TESCM, experience revealed the key drivers of a successful project to be:

- Business always comes first: tax models follow business models.
- Operational performance determines success in the long run.
- Substance needs to be relocated. Contractual rearrangements alone do not suffice.
- TESCM can foster better handling of business complexity.
- Successful implementation can lead to enormous financial benefits.
- Accurate planning and sensible communication are critical.
- Incentives need to be aligned to the improved business model.
- The chosen TESCM approach depends on the structure and the business model of the firm.
- Challenges such as contract wording, tax ruling and IT-implementation can often be addressed by utilizing expert advice.
- Change Management should definitely include affected employees in solution development.

Overall, interviews reveal that while successful TESCM implementation represents a challenge, appropriate planning results in a significant financial reward.

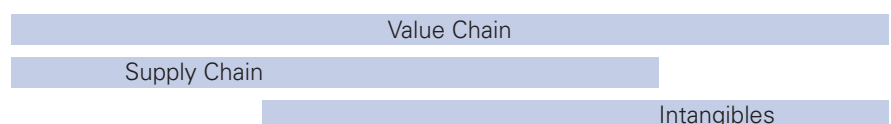
2 TЕСM – A Definition

For multinational corporations (MNCs), today's business environment is increasingly challenging. Fierce global competition, high customer expectations and shareholders who insistently demand enhanced financial returns pressure MNCs to increase their overall profitability. The volatile nature of the M&A market combined with capital scarcity often restricts external growth as a striking opportunity for improvements in financial returns. Organisations are therefore regularly forced to advance the performance of existing businesses to increase profitability.

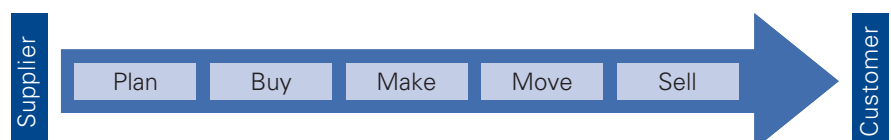
To tap the full potential of existing operations, MNCs face the challenge of determining appropriate cost optimization, process improvement and tax saving initiatives for their sector and size of business. Frequently, only realignment of the business model and reorganization of supply chain activities can substantially contribute to sustained improvements in operations followed by enhanced financial returns.

TESCM (Tax Efficient Supply Chain Management) comprises business strategies that adapt operations to a complex world, focusing on operational measures as well as on tax optimization

TESCM comprises business strategies that adapt operations to the changed commercial circumstances of an increasingly global and complex world. TESCM is recognised as the preferred business strategy for inherent, effective tax rate management. TESCM focuses on the entire value chain of a corporation, consisting of two main components: intangible assets and the supply chain.



Intangible assets include value drivers such as licenses, relevant brand names and trademarks, intellectual property (IP), know-how and technology, systems, processes and tools, control of human resources as well as training and products/ services manuals. Supply chains comprise the flow of goods, services, information and cash among business partners, such as suppliers, producers/manufacturers, distributors, logistics providers and retailers. Accordingly, they include all activities from the point of entry into the enterprise to the final exit and the eventual consumption by the end-user. Especially for multinational companies, supply chains are often very complex and spread out across multiple countries.

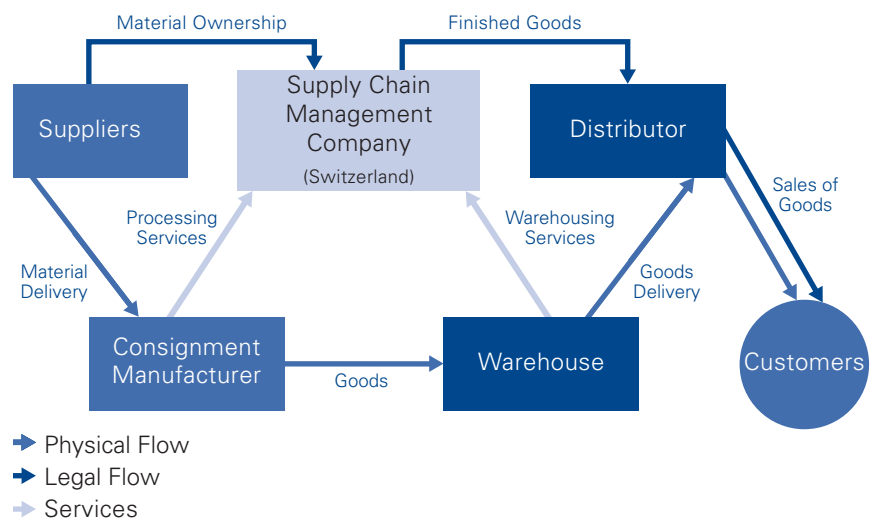


Due to their international scope, MNCs are faced with different tax laws, tax authorities and tax rates around the globe. The corresponding diversity of tax issues bears the risk of high tax payments associated with widespread operations.

While traditional supply chain management focuses on efficiency in operations, TESCO provides a comprehensive approach that concentrates on operational measures as well as on tax optimization. Through integration of tax planning into the design of supply chain structures, significant benefits beyond conventional operational savings can be realized. TESCO realigns functions, assets and risks, and incorporates tax planning into the redesign of the value chain, creating shareholder value through three major mechanisms:

- Realization of previously untapped supply chain benefits accessed through creation of centrally controlled strategic, tactical supply chain operations.
- Planning and management of tax implications of physical supply chain operations, including the flow of goods, location of assets and organizational structures.
- Reduction in the effective corporate tax burden combined with a reduction in indirect taxes paid.

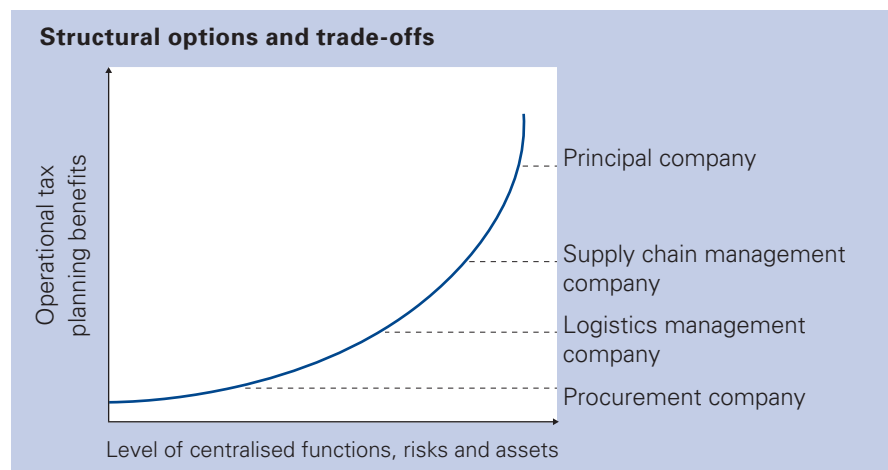
Key value-adding activities, functions and risks are shifted to a Supply Chain Management Company which has a low effective tax rate



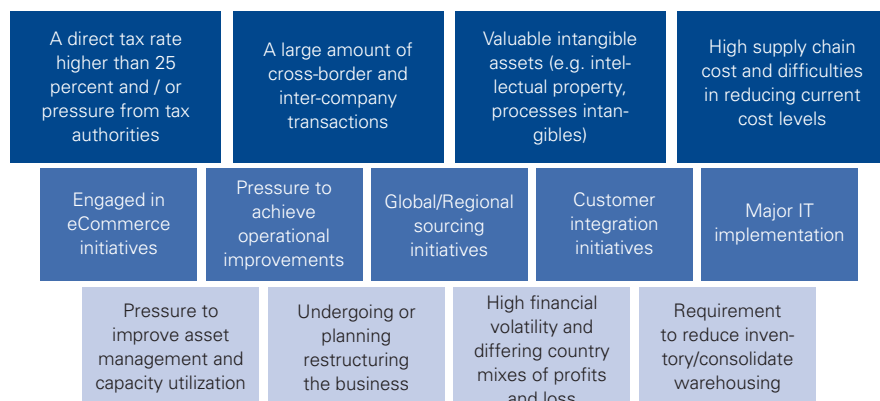
An entity's retained profit is based on its functions (work performed), assets (what it owns), and risks (what it can lose if things go wrong)

By shifting key value-adding activities, functions and risks to a centralized supply chain management company (Principal entity) with a low effective tax rate, TESCO captures the full potential in a corporation's financial performance.

For tax considerations, economic substance is of primary importance in Europe and Switzerland. Tax authorities recognize a Principal structure that demonstrates economic substance not only conceptually, but also in daily business practice.



The greater the substance relocated, the greater the achievable tax benefit. The TESCO approach may be an especially viable opportunity for companies with these attributes:



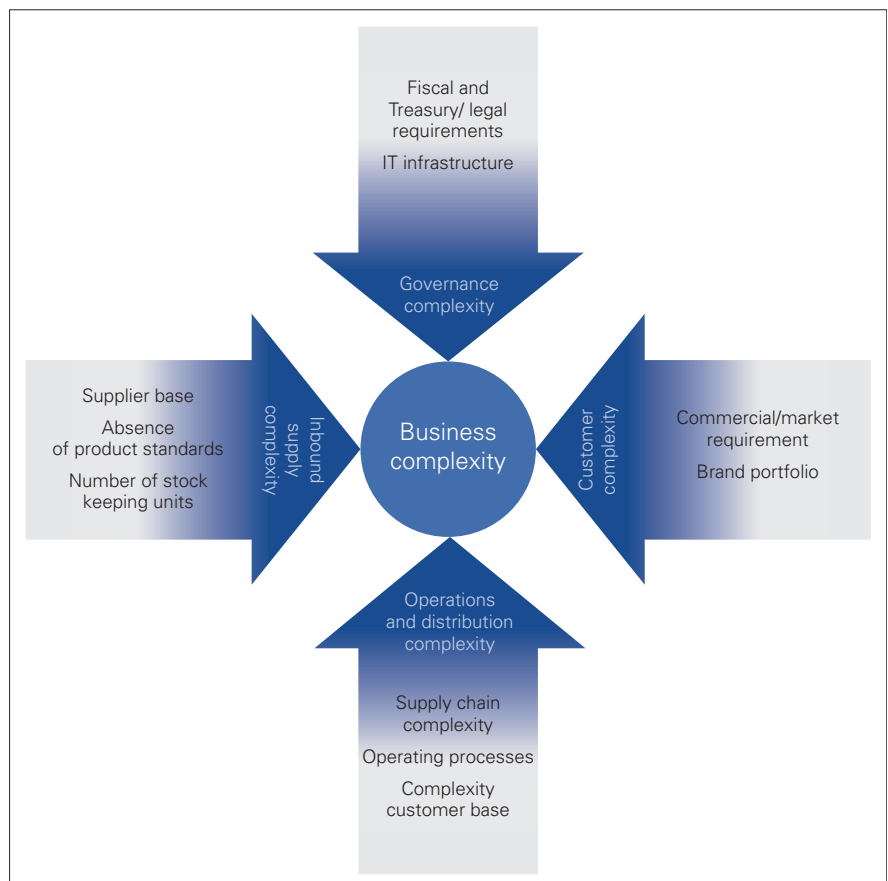
TESCM confronts and resolves business complexity, optimizing the value chain through a realignment of functions, assets and risks

Business Complexity a Driving Force for TESCM

Today's business world offers diverse opportunities to invest, source, manufacture and distribute all around the globe. The variety of opportunities can be promising, but also radically increases the complexity of global business. This is particularly true for supply chain operations.

For instance, leveraging production by shifting manufacturing to low cost countries can seem favorable at first. However, potential downsides such as delays in delivery, complicated logistics, confusing regulations and multiple tax responsibilities can quickly consume initial profits. Tighter fiscal and legal requirements, complications of a growing customer base and of inbound supply, as well as operational and distribution challenges can compound business complexity further.

What is the optimal response to this complexity challenge? How can increasing complexity in operations be addressed effectively?



There is no patent answer for all MNCs. Addressing increasing business complexity requires firm-specific solutions adapted to business needs. TESCM confronts and resolves business complexity. By optimizing the value chain through a realignment of functions, assets and risks, TESCM strategically implements effective complexity management. Thus, the inherent complexity of business that comes with the territory for multinational companies drives the need for solutions that TESCM can provide.

The centralization of functions in a Principal model enhances management control and organizational efficiency

Enormous Financial Benefits

The financial benefits achievable through TESCM initiatives provide clear incentives to carry out a project. However, benefits from TESCM projects generally do not only include tax savings but also result to a large extent in operational savings.

Planning technique	Current status	Reputation risks	Longevity	Business impact	Type of benefits
Financing	Significantly curtailed	High	Short	Virtually none	Tax only
Transfer pricing	Expanding	Low-Medium	Long	Low	Tax only
TESCM	Expanding	Low-Medium	Long	High	Business and tax

Operational savings are gained from a restructured, superior business and operating model that realigns functions, assets and risks. The centralization of functions in a Principal model enables enhanced management control and contributes to organizational efficiency.

International benchmarks rank Switzerland as an ideal location for a Principal entity

The Choice of a Principal Location

The choice of location for a Principal entity is one crucial element of successful TESCM implementation. A location's attractiveness depends on tax and non-tax related considerations (e.g. infrastructure, regulatory environment, quality of life). International benchmarks rank Switzerland as an ideal location for establishing a Principal entity due to leading positions in tax and non-tax related country features. On the tax side, Switzerland is attractive for both favorable tax rates and the open attitude of Swiss tax authorities, who look to increase investment in the country. Overall, international corporations favor Switzerland due to the country's balance of the following factors:

- low tax rates
- quality of life
- location in the heart of Europe
- logistics – international airports, roads and railways that traverse the Alps
- highly qualified workforce.

3 Switzerland – The Location of Choice for a Principal Company

Switzerland has improved its appeal to foreign multinational corporations, in part due to intercantonal competition in tax attractiveness

3.1 Switzerland since 1990

Since 1990 Switzerland has continuously improved its appeal to foreign multinational corporations, attracting increased foreign direct investment. Switzerland's development as a low tax jurisdiction is primarily due to its cantonal tax structure. The 26 sovereign cantons compete in tax attractiveness to draw in foreign MNCs. Instead of draining single local tax payers too heavily, cantonal tax policies focused on broadening the funding basis by attracting additional tax payers. This led to settlement of an increased number of Principal companies in Switzerland. As tax competition is ongoing, in the future MNCs can rely on effective tax rates that are significantly below Switzerland's peers. Taxation has not been the only area of improvement in Switzerland since 1990. The country also invested heavily in infrastructure, education and public transportation. The mixture of a favorable tax environment, reliable and efficient infrastructure, highly educated workforce and excellent public transportation made Switzerland the country of choice for many MNCs wishing to restructure their European operations. This trend is expected to continue.

Switzerland is not a member of the European Union, but bilateral treaties allow virtually frictionless transfer of goods and services to and from EU member states

3.2 Switzerland and the European Union

Switzerland is not a member of the European Union (EU). However, the relationship with the EU is governed by a comprehensive free trade agreement and a number of bilateral treaties allowing virtually frictionless transfer of goods and services between Switzerland and the EU member states. For tax purposes Art. 15 of the savings agreement is especially important, which entitles Swiss corporations to a 0% withholding tax for dividends, royalties and interest received from EU group companies under certain conditions. This system of contractual agreements and treaties makes Switzerland an integral part of the European market with its 360 million consumers. Nonetheless Switzerland preserves its political independence, enacting regulation that fits local businesses best.

3.3 Switzerland in Figures

15,941 square miles	20 percent non-Swiss population
4 national languages	42 hours average working week
7.3 million inhabitants	4–5 weeks vacation
2 federal institutes of technology	6000 foreign companies
9 universities	680 North American companies
2 of the world's top 10 pharmaceutical companies (Novartis, Roche), many small and mid-sized life science companies	International or European HQs of major global firms (Straumann, Synthes, Zimmer, Medtronic, ABB, PMI, Nestle) and numerous smaller companies
2 European R&D centers (Google and IBM)	2 major global banks (UBS and Credit Suisse)
⅓ of the world's wealth managed by Switzerland's financial centers	2 nd most Fortune 500 companies per inhabitant
2 nd largest EU export partner after USA	4 th largest EU trading partner after USA, China, Russia – ahead of Japan

Source: Location Switzerland 2006, Staatssekretariat für Wirtschaft (SECO)

3.4 Taxation in Switzerland

Corporate Income Taxation

Swiss residential corporations are generally taxed on their worldwide income, except for income which is derived from permanent establishments abroad. Such income is exempt from taxation in Switzerland. As the Swiss Confederation consists of 26 sovereign cantons and approximately 2,800 independent communities, the right of taxation does not rest exclusively with the federal government. Instead, there are three levels of taxation: the federal, the cantonal and the communal level.

Corporate income tax at the federal level is levied at a flat rate of 7.83% (effective tax rate) of net profit. Cantonal/communal taxes depend on the canton and the municipality in which the company resides. Therefore the combined effective ordinary tax rate for federal, cantonal and communal taxes varies from around 12% to up to 24% of net income. In contrast to many other countries, corporate taxes are generally deductible from net income. This effect is already included in the effective tax rates shown.

Three levels of taxation, federal, cantonal and communal, result in an effective ordinary tax ranging from 12% to 24% of net income

Taxation as a Principal Company

The effective tax rate applicable for principal companies depends mainly on the following three circumstances:

- Cantonal domicile
- Taxation as a mixed company at cantonal/communal levels
- Deemed permanent establishment (PE) allocation

1. Cantonal domicile

As shown above, the ordinary tax rates of the different cantons vary substantially. Therefore, the choice of cantonal domicile is a major consideration for effective tax-efficient management.

2. Taxation as a mixed company at cantonal/communal levels

Mixed companies are – on cantonal level only – taxed according to their business activity in Switzerland. The mixed company status is regulated in the respective cantonal tax laws. However, the conditions do not differ significantly among the cantons. If a company qualifies for this unique status the applicable cantonal/communal income tax rate can be reduced by approx. 80%, resulting in a combined effective tax rate of approx. 9 to 12% (depending on cantonal domicile).

3. Deemed PE allocation

Under certain circumstances, a Swiss Principal Company can allocate part of its sales related profit to a deemed foreign PE which can lead to a further tax rate reduction of approx. 3%. This results in a combined effective tax of 6%.

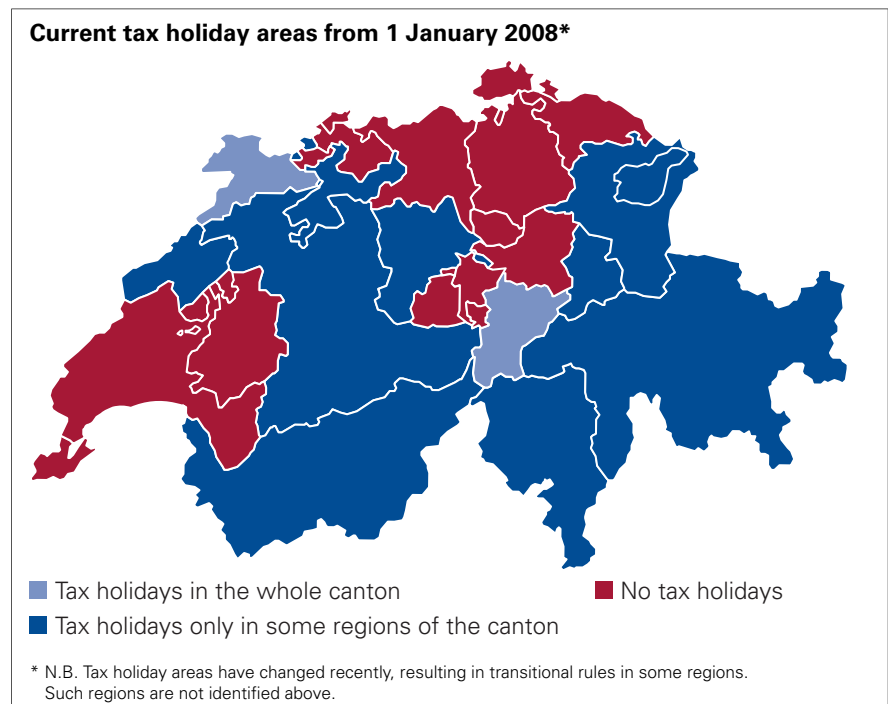
The favorable tax treatment of principal companies and the considerable amount of potential tax savings are not only applicable to corporations which relocate a centralized supply chain management company to Switzerland. Instead, companies already located in Switzerland can also benefit from the same tax treatment.

Tax Holiday

Tax holidays of up to 10 years may be granted for relocating new business activities into cantons or communities judged economically underdeveloped. The parameters for obtaining such a tax holiday are defined by law and include among other factors the quantity of new works space created and the significance of the investment for the region. Swiss Principal Companies can qualify for such a tax holiday. In this case the applicable combined effective tax rate for the Principal Company can be lowered to 0% for a period of 10 years.

Tax rate can be reduced to 0% for a period of 10 years in cases when a tax holiday is granted

The following picture gives an overview of communities in which tax holidays are granted on federal and cantonal/communal levels:



Stamp duty on issuance of shares

Issuance of shares of a Swiss company or any contribution to the equity of such a company is subject to a 1% stamp duty. However, the establishment of a Swiss Principal Company generally can qualify as a reorganization from a Swiss tax perspective and therefore be exempt from stamp duty.

Withholding taxes (WHT)

Switzerland has a very extensive tax treaty network, and through a bilateral agreement with the EU accedes to the EU parent/subsidiary and royalty/interest directive. This results in a 0% WHT rate on dividend, royalty and interest payments within EU and Swiss group companies. Switzerland does not levy WHT on interest payments on group internal loans and royalty payments under domestic law.

Value Added Tax (VAT)

Value Added Tax (VAT) in Switzerland is levied by the Federal Tax Administration. The standard rate amounts to 7.6% and is levied on most goods and services (2.4% and 3.6% reduced rate). The Swiss VAT regulations are similar to the regulations of the EU and therefore basically compatible with the EU VAT system. Compared to many other European countries such as Germany (19% standard and 7% reduced rate), Austria (20% standard and 12%/10% reduced rate), the

UK (17.5% standard and 5% reduced rate), VAT in Switzerland is relatively low. Supplies within the EU are usually subject to VAT in one of the EU member states. Swiss companies delivering supplies within the EU are usually obliged to register for VAT in one or more EU member states. Supplies a Swiss company delivers within the EU are exempt from Swiss VAT upon fulfillment of certain conditions.

Transfer Pricing

Transfer pricing becomes an issue in virtually any inter-group transaction. In order to establish a sustainable principal structure, transfer pricing issues need to be carefully evaluated. This includes proper documentation and compliance with local standards. In Switzerland, there is no special law governing the transfer pricing methodology. Instead, Swiss tax authorities allow Advanced Pricing Agreements (APAs), which constitute individual agreement between the taxpayer and the tax authority on a suitable methodology for transfer pricing. APAs are particularly helpful for companies restructuring their business activities since the needs of the reorganized firm can be taken into account and incorporated into the agreement.

Personal Taxation

Residents of Switzerland are subject to income tax based on their worldwide income. Tax relief is available for income from foreign sources based on a broad double tax treaty network

Personal taxes in Switzerland depend on the canton and community in which an individual lives, works or has otherwise invested. Those individuals deemed "resident" for tax purposes in Switzerland are subject to income tax based on their worldwide income regardless of source. A tax relief (exemption with progression) is available for foreign income sources based on a broad double tax treaty network. Due to the interrelation of federal, cantonal and communal taxes and a variety of available deductions, there is no single tax rate applicable to all residents in Switzerland.

Federal income taxes are progressive with a zero rate on the first income bracket, followed by nine brackets with increasing rates, reaching a maximum of 11.5%. Cantonal and communal tax rates vary widely. For example, Wollerau has a comparatively low approximate marginal tax rate of 20%, including federal tax, while Geneva has a rather high approximate marginal tax rate of 46%, including federal tax. Due to cantonal tax competition, even the more expensive cantons tend to charge substantially less than other countries in Europe.

Some cantons have introduced special tax deductions for international assignees (expatriate deductions) in connection with costs arising from an international move (double housing costs, moving costs, international schooling). Tax deductions in this respect are not granted to local employees. However, the expatriate deductions are a practice-based approach which may change in the future. It is therefore recommended that companies seek a ruling with the tax authorities granting a deduction for international assignees.

Swiss tax authorities support timely negotiation that enables potential new investors to establish residency in Switzerland within a reasonable time

Ruling System

Tax rulings are possible in practice with regard to all applicable taxes in Switzerland. It is common practice that special circumstances and their tax consequences can be discussed in advance with the tax authorities. An advance ruling is binding for the tax authorities provided all the relevant facts have been disclosed and no change of the tax law occurs. Normally, Swiss tax rulings are not temporally limited. Swiss tax authorities have a very long tax ruling practice and are well known for their service oriented approach in support of a timely negotiation result that enables potential new investors to establish residency in Switzerland within a reasonable time. Local tax payers are treated in the same way and an open relation towards the authorities is normal. Tax rulings can normally be obtained within 4 to 6 weeks.

Switzerland ranks high in quality of living; the choice of Principal Company location depends strongly on high living standards

3.5 Quality of Life, Infrastructure and Workforce

Establishing a Principal Company always requires the relocation of key decision makers and employees. When it comes to relocation, factors such as living standards, infrastructure and available workforce become important. Among many factors, high living standards at the Principal's location are among key criteria. As decision-makers and employees are often relocated with their families, quality of educational systems, public safety and opportunities for leisure activities are significant.

As reported by the Mercer Human Resource Consulting Worldwide Quality of Living Survey 2007, three of the top ten international locations with respect to quality of living are located in Switzerland.

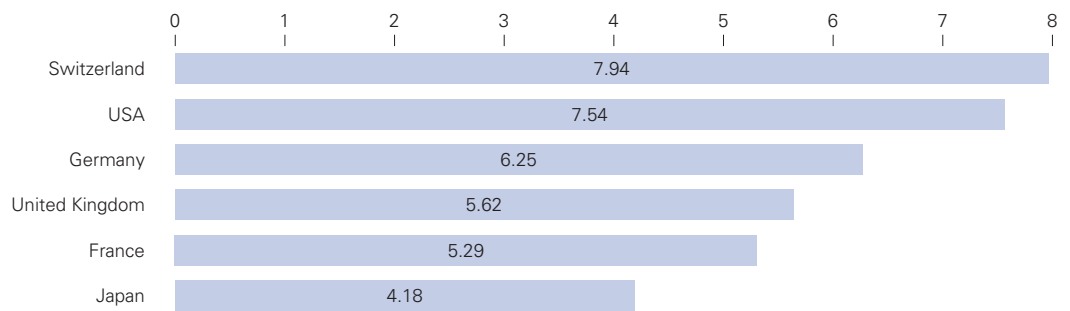
Rank 2007	City	Country	Index 2007
1	Zurich	Switzerland	108.1
2	Geneva	Switzerland	108.0
3	Vancouver	Canada	107.7
4	Vienna	Austria	107.7
5	Auckland	New Zealand	107.3
6	Dusseldorf	Germany	107.3
7	Frankfurt	Germany	107.1
8	Munich	Germany	106.9
9	Bern	Switzerland	106.5
10	Sydney	Australia	106.5

Source: Mercer Human Resource Consulting Worldwide Quality of Living Survey 2007
(Base City: New York, USA=100)

Swiss employees are well qualified to meet the needs of a competitive economy; senior managers have exceptional international experience

In cases where relocation of key decision makers is not possible, the company has to rely on hiring locally. The local labor market is characterized by employees with university education that meets the needs of a competitive economy and by senior managers with comparably exceptional international experience.

University education (2008)



International experience of management (2008)



Source: IMD, The World Competitiveness Yearbook 2008, Executive Opinion Survey based on an index from 0 to 10 (10 = highest possible score)

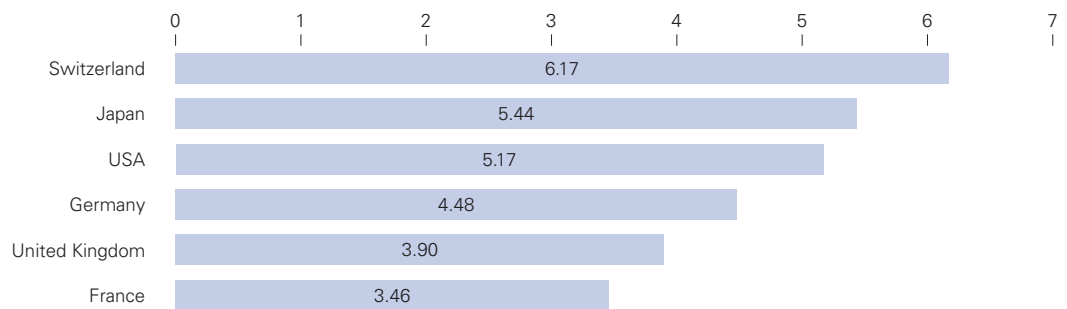
Additionally, due to an increasing number of Principal Companies in Switzerland, there are experienced management personnel available including TESCM experts. Therefore, companies striving to establish a Principal entity in Switzerland are not expected to face a shortage in human resources.

A business-friendly legal and regulatory environment enhances Switzerland's attractiveness

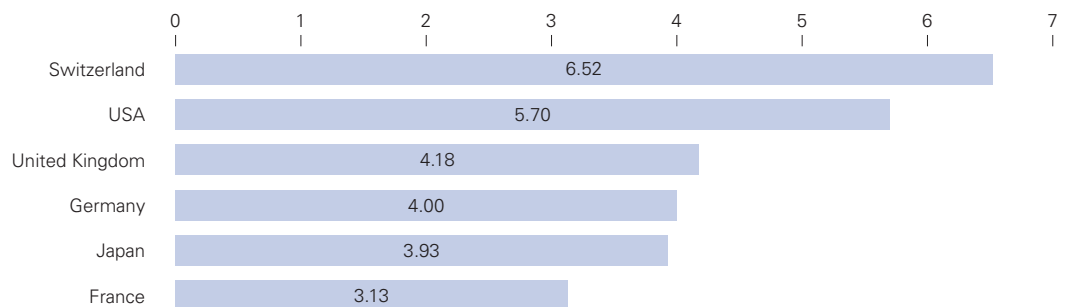
3.6 Legal and Regulatory Framework

Switzerland's business-friendly legal and regulatory environment substantially enhances its attractiveness as a location for a Principal Company. The overall intensity of regulation in Switzerland is considered relatively low and does not inhibit the ability of companies to compete. Furthermore, the legal and regulatory framework is experienced as encouraging of enterprise competitiveness.

Low regulation intensity (2008)



Encouraging legal and regulatory framework (2008)

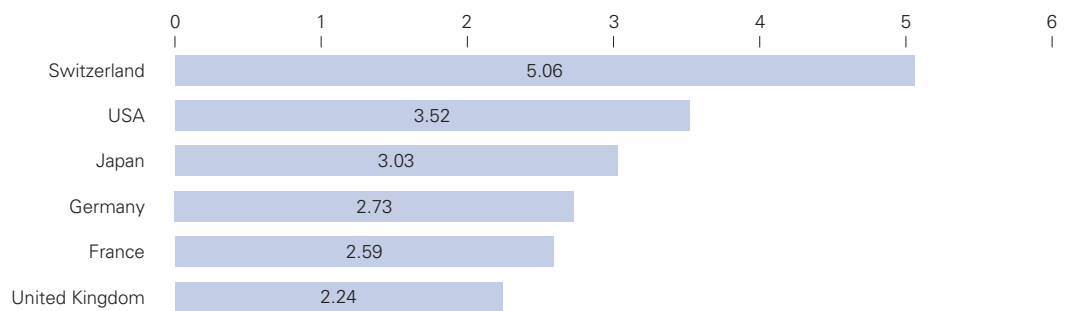


Source: IMD, The World Competitiveness Yearbook 2008, Executive Opinion Survey based on an index from 0 to 10 (10 = highest possible score)

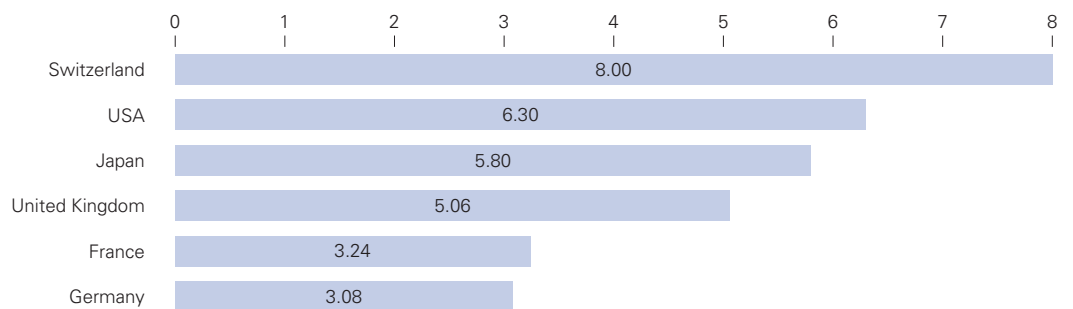
Switzerland's distinguished position as a business-friendly regulatory environment is enabled by a remarkable absence of bureaucracy.

Labor regulations such as hiring/firing practices and minimum wages do not hinder business activities in Switzerland. The country's remarkable position regarding labor regulation relative to its peers is essentially due to flexible labor laws.

Bureaucracy does not hinder business activities (2008)



Labor regulation does not hinder business activities (2008)



Source: IMD, The World Competitiveness Yearbook 2008, Executive Opinion Survey based on an index from 0 to 10 (10 = highest possible score)

3.7 Logistics

Further, an excellent road network, the availability of public transport and international airports play a decisive role. From Switzerland, virtually any major European city can be reached by plane in less than one hour.



Source: Location Switzerland, Staatssekretariat für Wirtschaft (SECO)

Switzerland's road and train networks offer timely and reliable transportation within the country as well as across the Alps.

Cantonal differences allow corporations to choose the business environment that fits their needs best

3.8 Cantonal Differences

Cantonal differences apply not only to taxes but also to infrastructure, shopping possibilities, educational systems and workforce availability. The main variations can be identified between the infrastructure in major cities such as Basel, Bern, Geneva and Zurich and that in rural areas such as the cantons Appenzell or Graubünden. Other cantons such as Zug, Schwyz and Schaffhausen combine both infrastructure and competitive tax conditions. These cantonal differences allow corporations to choose the business environment that fits their needs best. For example, companies requiring considerable space for local facilities may choose a more rural area. If proximity to an international airport is considered more important, a major city is a better choice.

4 TЕСM Projects in Switzerland

4.1 Initiating a Project

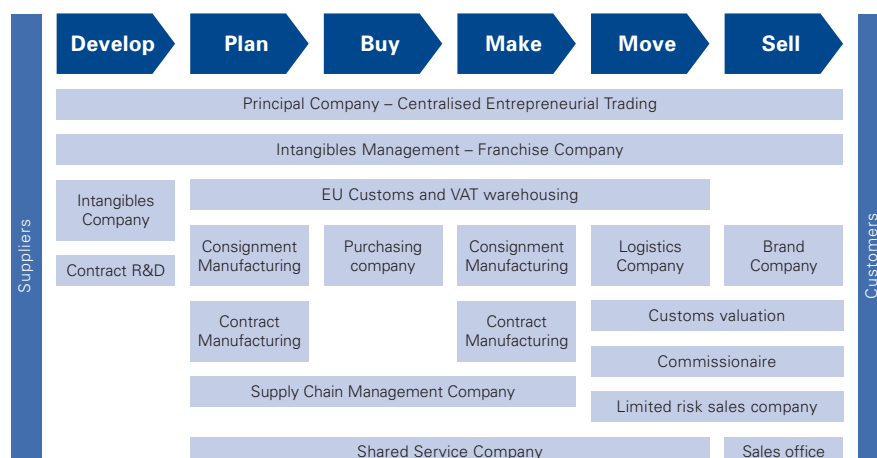
Successfully initiating a TЕСM project requires appropriate

- preparation and planning
- communication and
- incentives.

Preparation and Planning

The first significant step in any TЕСM project is sound analysis of a company's existing value chain. Tax models have to be consistent with business models and TЕСM related changes should be properly documented and integrated within a corporation's business plan. Moreover, since business models are highly unique, duplicating another company's TЕСM experience is rarely possible. Consequently, ascertaining major efficiencies and potential tax savings requires expertise in supply chain, industry and tax know how. Because a Principal structure establishes a high degree of functional centralization, the Principal status may not be the model of choice for all firms.

TESCM projects require expertise in supply chain, industry and tax know-how



Communication

Because tax optimization programs are perceived differently among stakeholders, external communication should be reduced to the minimum level possible. On the contrary, internal communication must be an integral part of project management and carefully planned. Local management can often only be motivated through a clear commitment from general management. Communication should address all employee levels.

Internal communication is an integral part of TЕСM project management and incentive structure is critical to avoid resistance

Incentives

An appropriate incentive structure, key in any restructuring process, is critical for TЕСSM initiatives as well. The management of subsidiaries needs particular attention, since preservation of power and influence at the local level – a foreseeable reaction – countermands the centralization of functions within the Principal entity. In order to avoid resistance to change at the local level, incentive systems require realignments and alterations in advance. Often TЕСSM requires a new set of performance metrics along with the change in the business model.

4.2 Realizing a TЕСSM Project

Successful realization of a TЕСSM initiative requires

- a decision on pursued approach,
- proper allocation of resources, timing and
- rigorous tackling of problems and challenges.

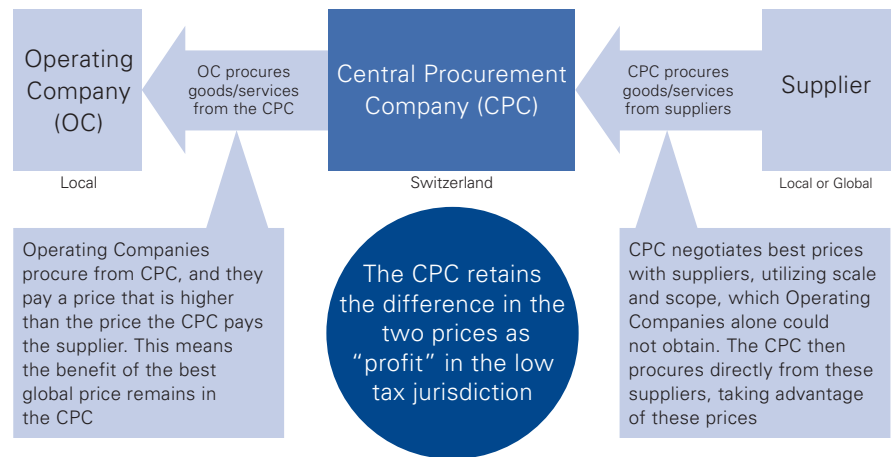
TЕСSM Approach

There are three TЕСSM implementation approaches: discrete, incremental or fully transformational

Implementations of the Principal model differ significantly in structure. The decision on which functions or regions to integrate in the Principal model depends strongly on the unique characteristics of the MNC. Not only the current state of operations (i.e. level of business process standardization, global IT system, etc.), but also the future strategy play a vital role.

While each case for TЕСSM implementation must be decided individually, three general classifications of approach can be pursued: TЕСSM programs can be discrete, incremental or fully transformational depending on a client's specific needs.

- Tax-Efficient Procurement – the centralization and tax-efficient location of procurement operations can deliver significant benefits with less restructuring than a full TЕСSM program. Many KPMG clients have had great success in using Tax-Efficient Procurement as part of wider transformation activities.



- Tax-Efficient Distribution – TЕСM programs that address structure and location of sales, marketing, logistics and inventory activities are well suited to businesses with wide-spread and complex distribution networks.
- Tax-Efficient Manufacturing – companies restructuring global manufacturing activities find that incorporating tax considerations improves the business case for these programs substantially.
- Tax-Efficient IP – managing valuable intellectual property rights is increasingly on the agenda of executives. Opportunities abound for companies to derive benefits by managing IP in a tax-efficient manner.

CASE STUDY A leading FTSE-100 telecommunications company globalized procurement activities resulting in multi-million Euro annual savings. By aligning the globalization activities with implementation of a tax-efficient procurement company, further significant tax savings were achieved. Co-location of procurement specialists created further qualitative benefits such as increased knowledge sharing and sourcing efficiencies.

Resource allocation is key; external resources can be advantageous for lean operations

Allocation of Resources and Timing

The time horizon to complete implementation will differ from one company to another. Resource allocation is a key element significantly influencing project length. The use of external resources can be costly, but works very well for companies with lean operations wishing to maintain focus on daily operations. Additionally, payback periods of TЕСM initiatives are often very short.

Other considerations include legal advice, business case, relocation of key decision makers and IT system adaptation

Rigorous Tackling of Problems and Challenges

Many companies recognize potential gains in supply chain efficiency, but must weigh the required extent of change. Some important challenges are:

- **Transfer pricing**
To successfully justify lower margins at the local level, transfer pricing must be acceptable to local tax authorities. Satisfying requirements of various tax regimes in different countries depends on expert advice.
- **Contracting**
A key requirement for receiving Principal status is modification of existing contracts with manufacturing and sales entities. Local subsidiaries may have to be split legally into sales and manufacturing companies. The use of consignment manufacturers also requires establishment of service agreements. Legal advice will be needed to draft sustainable contracts.
- **Ruling**
Rulings occur at federal and cantonal levels in Switzerland. To achieve Principal status efficiently, a ruling application must be pursued in a disciplined, detailed manner. Demonstrating the business case for restructuring the value chain to tax authorities outside Switzerland is a more difficult aspect.
- **Relocation**
To demonstrate economic substance at the Principal location, key decision makers must relocate to Switzerland. Relocation also depends on the attractiveness and the image of the company. International corporations that already have a number of mobile expatriates may have more ease of practice with the relocation process.
- **IT System Migration**
After an optimization of the value chain, the new business processes need to be mapped to the IT system. A corporate-wide ERP solution might facilitate the implementation best. Integration of unlike systems can be complex, tedious and costly.
- **Support by Swiss location promotion agencies**
The cantons operate location promotion agencies to assist foreign corporations wishing to invest in Switzerland with many of the related issues. The support can be very helpful and for MNCs relocating to Switzerland contact with the responsible agency in the chosen canton is recommended.

5 Survey Results: Practical Experience in Switzerland – How Others Succeeded

This chapter summarizes our survey findings and reexamines our assumptions about key drivers of TЕСM. Additionally, we present revealed best practice, especially regarding change management and involved functions. Interviews were conducted with industry professionals from 12 international corporations that are currently executing TЕСM initiatives or have already completed such projects.

Industry backgrounds include

- food and related products
- financial services
- industrial, commercial machinery and equipment
- chemical products
- electronic and electrical equipment
- games, toys and children's vehicles
- transportation and logistics services
- dental equipment and supplies
- electro-medical and electrotherapeutic devices

We also interviewed other TЕСM stakeholders such as economic promotion agencies, tax authorities and lobbying professionals. These results are also incorporated into our findings.

5.1 Driving Forces of TЕСM – The Practical Experience

Business Complexity

For many of the interviewed firms, increasing complexity of their businesses was a driving force for starting a TЕСM initiative. Increased complexity was often due to either high growth rates or an organizational structure not adjusted to current business needs.

Practice Statement:

"In order to regain control over our fast growing European operations, we were forced to restructure our supply chain," said one interviewee, adding that "besides tax advantages the major and key benefit in our TЕСM project arose from the simultaneous optimization of the value chain."

The enhanced transparency in manufacturing operations was considered especially valuable by our interviewees. Increased transparency also enabled improved controlling and continuous benchmarking in manufacturing operations. Interviewees considered the introduction of a Principal structure as increasingly advantageous for corporations with relatively high manufacturing intensity.

Financial Benefits

All interviewees agreed that enormous financial benefits can be realized by setting up a centralized Principal structure, but also emphasized that tax follows business.

Practice Statement:

“There are tremendous benefits achievable if the Principal structure is correctly implemented.”

Some interviewees also stated that benefits from a Principal model are more noticeable if the company is already profitable. By contrast, delegating decision makers to Switzerland during a period of losses might incur costs that exceed incremental tax savings. Project costs must be regarded as an investment which is necessary before any tax savings can be achieved. Even if the expected benefit of a Principal structure is known in advance, external costs still need to be incurred.

Practice Statement:

“Overall, total benefits by far exceed total costs. Centralized controlling of functions, such as strategic procurement and marketing is not only profitable with respect to taxes but also rationalizes and optimizes business processes.”

Our interviews reveal moreover that once the structure is set up, companies consider integrating more and more functions into the Principal model.

5.2 Switzerland as the Location of Choice – The Practical Experience*The Tax Environment*

All interviewees agree that the favorable tax environment on the corporate as well as on the personal level is one reason for choosing Switzerland as a Principal location. The interviewees experience effective corporate tax rates from 7%–17%. One company experienced a tax payments reduction of some 30 million Euros subsequent to the realignment of value drivers.

Practice Statement:

“Although tax reduction was not the main intention of introducing TESCM, we could cut our effective tax rate by about 6%.”

Virtually all interviewees emphasize that the attainable tax savings heavily depend on the specific business model of the firm and further on the cantonal domicile of the Principal structure. Locations such as Zug, Zurich, Vaud and Geneva are repeatedly mentioned as favorable. Apart from savings due to the specific tax framework for principle companies in Switzerland, several of the interviewed companies benefited further from tax holidays of up to ten years.

Quality of Life, Infrastructure and Workforce

Although taxes play an important role, the interviewed companies emphasize that other factors are crucial for the final decision.

Practice Statement:

"Low effective tax rates help to get on the short list, but it is by far not the only criterion. A successful transfer of key employees into the country of the Principal location is even more important."

Standard of living is the most decisive factor in establishment of a Principal in Switzerland for most interviewees. As reported, many expatriates even extend their planned working period in Switzerland voluntarily, a striking indication of their satisfaction.

Practice Statement:

"We had a procurement manager from the U.S. who was supposed to assist in the TЕСSM set-up at the Swiss Principal for a couple of months. He has now lived near Zurich with his family for 2 years," said one CEO, who further points out that his employee "is overwhelmed by the politeness of the people, the wonderful landscape and the way of doing business in Switzerland."

Nevertheless, some interviewees state that a higher number of international schools would be favorable to attract even more employees and their families.

A disadvantage of the high standard of living is the corresponding cost. Some companies criticized comparably high costs for expatriates' relocation packages.

Infrastructure was often understood by our interviewees as proximity to an airport. Industry clusters evolve more frequently around airports than in rural areas. Despite Switzerland's high standard of living, many relocated employees choose to travel back home during weekends and holidays. Additionally, the centralization of decision functions combined with decentralized production plants and sales organizations naturally requires more traveling. Accordingly, Zurich and Geneva are often mentioned as preferred locations by the interviewees. Rail access to airports is considered a positive feature.

Concerning logistic activities, most interviewed companies assess Switzerland as a location of choice for European logistics.

Practice Statement:

“Especially the central location in Europe motivated us to choose Switzerland as our headquarters to coordinate European logistic operations.”

Further, the efficient infrastructure and the frictionless flow of physical goods and information are experienced as significant advantages by most of the interviewees.

Practice Statement:

“Transport timeliness is especially high in Switzerland, enabling accurate and dependable planning and execution of deliveries.”

Concerning workforce, the interviewed companies did not experience a notable shortage in human resources. Rather, many believe that Switzerland attracts qualified and experienced staff.

Practice Statement:

“We had a shortage of employees in the middle management when we relocated to Switzerland,” said one CEO, “but we were surprised about the availability of highly skilled people in the Swiss economy.”

Legal and Regulatory Framework

Communication with Swiss authorities is generally perceived as very professional and cooperation is even characterized as positive. The potential for tax negotiations is considered to be higher at the cantonal than at the federal level.

Although a Principal ruling is clear from a legal standpoint, arranging the required contact takes some time.

Practice Statement:

“When we came to Switzerland to establish our Principal structure, we found the Swiss authorities open to negotiations and willing to create a win-win situation. But it is highly important to get local counsel on board to facilitate negotiations and speed up the incorporation of the Principal.”

Once a Principal structure is setup, most of the interviewed companies assess the degree of bureaucracy in Switzerland as moderate and fair. From a political point of view, our interviewees consider Switzerland very stable. The only risk mentioned is a decline in the relationship between Switzerland and the European Union.

Cantonal Differences

The twelve interviewed companies were located in Zurich, Zug, Basel, Geneva, Obwalden and St. Gallen. Based on their TЕСM experience, the interviewees recommend an in-depth evaluation of several cantons and cities before the set up of the Principal structure.

Key Findings – Location Switzerland

- Favorable tax environment
- High quality of life
- Efficient infrastructure
- Qualified workforce
- Positive legal environment
- Cantons offer variety of opportunities

5.3 Project Initiation – The Practical Experience

Preparation and Planning

All our interviewees agreed that sound preparation and planning is essential to successfully initiate a TЕСM project.

Practice Statement:

“The TЕСM preparation phase was absolutely vital. Only by having a detailed look at our operations could we develop a deeper feeling for what really needed change.”

Communication

From the point of view of our interviewees, there was no need for external communication if there was no significant change for the customer. With respect to internal communication, some interviewees pointed out that project acceptance is generally higher if employees are aware that TЕСM is not only a tax project but also an optimization of the business model.

Incentives

Alterations of incentive structures were considered by many interviewees. Most adjusted revenue targets for local units to compensate sales representatives for shrinking margins. Some interviewed companies also kept previous transaction flow systems in place to make changes transparent. Another possibility considered by an interviewee was to change incentives entirely, i.e. from a profit-based to a quality-based bonus system.

Practice Statement:

“With the change of scope of local operations, it was a natural choice to adapt our incentives accordingly. Local management formerly responsible for profits is now accountable for quality and gets compensated in favor of it.”

5.4 Project Realization – The Practical Experience

Integration by Functions

As a result of our interviews, it became obvious that the chosen sequence of integrated functions depends on the organizational structure of a firm. One of the interviewed companies integrated the marketing department first, as it was previously operated as a competence centre and therefore already highly centralized.

Practice Statement:

“The shortcoming of this approach is that it can become difficult to keep daily operations running with a business model which is only partly implemented. Therefore, we had to keep the rollout period as short as possible.”

Integration by Products

As interviews revealed, implementation by products is often favored by technology-oriented companies. Depending on the complexity of the product and the organizational structure behind it, the rollout for a single production unit can vary from 3 to 6 months.

Allocation of Resources and Timing

Most interviewees decided to utilize external resources as far as possible in order to keep regular operations running.

Practice Statement:

“The most basic principle is: the project should not interrupt business and daily operations should not be affected until changes become effective.”

Rigorous Tackling of Problems and Challenges

Transfer pricing

The interviewed companies recommend counsel from an external partner to facilitate verification by local tax authorities.

Practice Statement:

“Transfer pricing can really become a problem because foreign tax authorities are increasingly aggressive and do not accept many formerly common practices any longer.”

Contracting

As well as with transfer pricing, our interviewees recommend relying on local lawyers to draft sustainable contracts.

Ruling

Experienced consultants are recommended by interviewed companies for effective establishment of systematic documentation of the desired business model.

Practice Statement:

“Our consultants also did some helpful lobbying with the tax authorities on our behalf.”

“It is very important that the management of local subsidiaries entirely understands the model in order to clarify it correctly to their responsible tax authorities.”

Interviewed companies mentioned that they generally had only small concerns about the relocation process. Average fluctuation of employees at the Principal level amounted to about 10% during implementation.

Practice Statement:

“Relocation also depends on the attractiveness and the image of the company.”

For MNCs, the relocation process was easier as they already have globally flexible expatriates. Appointing local firms to take care of organizational issues in relocation was recommended.

Practice Statement:

“Regarding relocation, we experienced both extremes: one company relocated its entire management; another did not transfer any people to Switzerland and hired entirely on the local market.”

IT System Migration

Some of our interviewees chose to migrate IT systems on a predefined day. This required intense system testing to avoid interruptions in daily business. Experiences of interviewed companies also show that certain problems are only discovered at the IT level and later on turn out to be business or tax problems.

Support by Swiss location promotion agencies

Our interviewees experienced support by location promotion agencies as helpful and constructive. Frequently mentioned was the advantage of having a local partner with experience in the process of establishing a Principal Company.

Change Management

Implementation of a Principal model represents a major organizational change for a company. Accordingly, change management is a crucial aspect during implementation. Many interviewed companies stated that the change of in organizational structure was less complicated than that needed for affected employees. Since a change management approach has to be adapted to a specific management culture, there is no single best practice. Resistance to change strongly depends on the actual situation. If business is going well (normally the case when introduction of a Principal is planned), even more resistance can be expected, because employees do not see any need for change. Typically, resistance from management of local operating units is strong. The Principal model is perceived as a threat to sphere of influence; centralizing functions and moving decision makers to the Principal location imply that less control and power remain at the local level.

Issues raised by companies as integral in change management were:

- Benefit of buy-in during initiation phase: top management commitment, quick-wins and long term benefits should be communicated.
- Knowledge dissemination: understanding of new processes, advantages of the Principal model and expected results must be made clear.
- Resource and expertise availability: experienced, knowledgeable employees should be appointed to the project, with outside experts to complement the team.
- Sustained reinforcement: successful change and negotiation to resolve internal resistance require determination.

The work on the Principal model is not finished with its implementation. Continuous improvement and optimization are ongoing processes: the system has to be maintained and contracts have to be kept current. Transfer prices should be updated on a yearly basis.

Research and Development (R&D) and Intellectual Property (IP)

Theoretical models suggest that existing IP should also be centralized. Nevertheless, our study indicates that existing IP rights are rarely transferred to the Principal. In particular this is due to significant expenses associated with transferring existing IP and a lack of predictability regarding longevity of the value of IP rights. The duration of brand values is difficult to predict. Alternatively, the Principal can own existing IP under license and resell it to the manufacturing entities.

Practice Statement:

“Regarding R&D, industry clusters are way more important than tax advantages.”

Procurement

Centralization of procurement is quite common. Strategic purchasing decisions are made centrally by virtually all interviewed companies. Operative procurement nonetheless remains in local manufacturing plants. If an existing supplier is suitable for other plants as well, purchasing orders are often initiated on a consolidated basis to benefit from scale effects. Flow of information is often controlled centrally but the flow of materials occurs directly to local plants. Besides releasing purchase orders, local manufacturers sometimes conduct supplier selection and contract negotiations on behalf of the central procurement function. In some cases, raw material is legally owned by the Principal throughout the entire value chain; in other cases the local manufacturer possesses legal title at least during the production process. Legal title at the local level can facilitate compliance with customs restrictions. Inventory risk is not always transferred to the Principal. But if the Principal owns the inventory, the value of the inventory does not only include production costs but also margins as devised in the transfer pricing agreements. For international corporations already having centralized procurement activities, the set up of the Principal is more a financial than a structural issue, especially as regards procurement.

Manufacturing

Manufacturing plants operate either on contract or consignment basis. Reimbursement functions on a cost plus basis for most of our interviewees. As agreed in transfer pricing, reimbursement may include expenses for raw materials, operating and infrastructure costs as well as a certain margin. In contrast to contract manufacturers, consignment manufactures do not possess legal title of manufacturing equipment and work in progress. Finished products always belong to the Principal Company. In practice both models are frequently used and no systematic preferences emerged in our interviews.

Separating product design from the manufacturing process was considered by one interviewee to create inefficiencies. Overall, it was acknowledged that the manufacturing cycle became significantly faster.

Sales & Marketing

Sales and marketing are controlled centrally by virtually all interviewees. Some but not all sales companies function as limited risk distributors. Most local distribution companies do not have profit responsibility. For a Principal Company, it is important to find a model that motivates its sales force, be it with incentives or other bonus systems.

Often dealers sell the products worldwide. Customers order directly at the limited risk distributor or dealer. The product is delivered from the production plant or a distribution centre directly to the customer.

Key Findings

- Business always comes first: tax models follow business models
- Operational performance determines long-term success
- TЕСSM confronts and resolves business complexity effectively
- Proper implementation yields enormous financial benefits
- Accurate planning and targeted communication are important
- Incentives should foster support of the improved business model
- The chosen TЕСSM approach depends on the firm and business model structure
- Expert advice can facilitate navigation of challenges such as contract wording, tax ruling and IT implementation
- Change Management must especially address affected employees
- General experience reveals:
 - Already existing IP is often not transferred to the principal
 - Strategic purchasing is centralized, while operational procurement remains on a local level
 - Both contract and consignment manufacturers are used viably
 - Sales and marketing are virtually always centralized

6 Outlook – TЕСM with KPMG

Is TЕСM right for your business?

The evolution of multi-national and global organizations means that TЕСM is rising up the agenda of senior executives. Understanding the differences between various tax jurisdictions makes location decisions possible which minimize the tax burden. Some primary characteristics of companies that can benefit from TЕСM include:

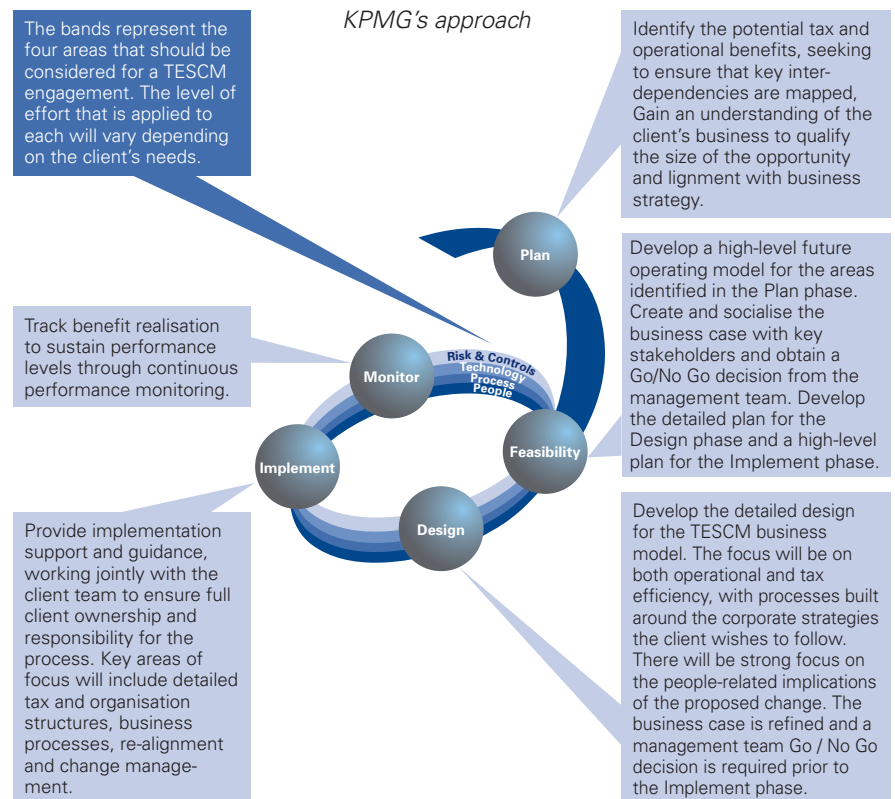
- Multinational operations, with revenues reported in multiple locations
- Complex supply chains, with high costs and decentralized operations
- Expansion into low cost locations for sales, sourcing and manufacturing
- High levels of cross-border and inter-company transactions
- A high effective direct tax rate
- Valuable intangible assets and intellectual property.

Many large businesses can be characterized by some or all of these issues. If yours is one of them, KPMG's TЕСM team can offer advice on the options available to you.

As globalization continues, efficient supply chain operations become even more important to keep pace with global competition. The relevance of geographically widespread operations and the need for efficient management capabilities enhance the importance of operational excellence.

MNCs' efforts to gain a global competitive edge will also increase the importance of intellectual property as a component of the value chain. Brand recognition, engineering know-how, manufacturing and service capabilities already shape today's business world and will grow in importance in the future.

These trends elevate the role TЕСM initiatives can play in making your business more competitive and especially more financially rewarding. Being first in your industry with a superior business model benefiting from realigned functions, assets and risks will pave your way to a successful future.



TESCM transformation programs impact several different parts of a business. Our teams are staffed to ensure that all areas receive appropriate attention. We deliver by drawing on resources and experience from across our Advisory and Tax practices, providing skilled, balanced teams, designed to meet the needs of each client. KPMG's TESC delivery teams typically include professionals from:

- Supply Chain Management
- Direct Tax / Transfer Pricing
- Indirect Tax / Customs & Duties
- Financial Management
- Program Management
- People & Change Management
- IT (excluding systems integration)

Case Study

A leading supplier to automotive Original Equipment Manufacturers and the after-sales market embarked on a European distribution network optimization. The program promoted an opportunity to consolidate primary distribution and inventory management to a pan-European supply chain function. Significant improvements in customer service levels and product availability resulted in revenue growth. Basing the future supply chain management in a tax-efficient location could yield an additional €100m benefit over four years with further annual benefits accruing to the top line.

Why choose KPMG?

At KPMG, we offer the strongest TЕСM proposition available today. Our capabilities enable us to help clients achieve improved value:

- Our People: Our team comprises key personnel that understand the project life cycle from opportunity assessment to implementation from both a client and advisory perspective within multinational organizations.
- Our Network: We have a dedicated network of TЕСM specialists throughout Europe, Asia Pacific and the Americas. This allows a whole client group to benefit from advice based on knowledge of each region in which the group operates.
- Our Flexibility: We work with clients by advising the evaluation, design and implementation strategies underpinned by relevant tax structuring which meet their commercial objectives.
- Our Experience: We have delivered significant TЕСM transformation programs for a number of global organizations. As an integrated advisory and tax team, we help identify and realize significant business and tax benefits.
- Our Independence: KPMG is an objective organization, offering measured and unbiased advice.
- Think Global – Act local: In Switzerland, KPMG has experienced teams highly qualified to establish your Principal location. The Swiss TЕСM teams have counseled numerous clients through a successful TЕСM initiative.

Case Study

A global electronics contract manufacturer was considering a shift in management model to a more regional approach. This would have a significant adverse impact on taxes payable in the next five years. By aligning the regional tax structures with the creation of two supply chain management companies, the company would achieve a more flexible regional management model while substantially reducing the growth of its effective tax rate. The business case for the combined initiatives estimated the cost avoidance to be in excess of €50m annually.

The KPMG experience:

“The KPMG team has worked with us on our tax optimized solution, the Central Procurement Company (CPC), from feasibility concept development, through design and implementation. The team has challenged and stretched us as a customer. Based on KPMG’s recommendations and phased implementation plan, we and KPMG worked together to deliver the CPC successfully. The CPC underpins much of the business case for our business transformation project and is therefore of critical importance to our business.”

Head of Supply Chain Strategy & Change, FTSE 100 Global Telecommunications company.

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