burckhardt

Rolf Wüthrich

International Tax Review Nr. 98, Mergers & Acquisitions, S. 34 – 38

Swiss tax avoidance practices in M&A transactions

Basel
burckhardt AG
Steinentorstrasse 23,
Postfach 258,
CH-4010 Basel

Zürich
burckhardt AG
Usteristrasse 12,
Postfach 1172,
CH-8021 Zürich

burckhardtlaw.com

Swiss tax avoidance practices in M&A transactions

Rolf Wüthrich of **burckhardt** describes the legal practices used by the Swiss authorities, which taxpayers should consider when concluding Swiss share deals.

In recent decades Switzerland has developed a long-lasting practice on the requalification of taxable dividends into tax-free capital gains and on the avoidance of treaty shopping to eliminate or mitigate reduced Swiss withholding tax consequences.

The practices described hereafter are:

- Domestic and international indirect partial liquidation;
- Domestic and international transposition;
- Theory of old reserves;
- Deemed liquidation; and
- Transfer of a shell company.

In the domestic context the Swiss tax code regulates the requalification of a tax-free capital gain of a Swiss resident person into a taxable dividend.

In the international context the Swiss tax administration focuses on a possible refusal of the otherwise applicable withholding tax rate due to the change of ownership as a consequence of a share deal. By picking up the argument of an inherent, unwritten principle of tax avoidance underlying tax treaties, the administration, supported by the jurisprudence of the Swiss Federal Supreme Court, argues that distributable reserves existing at the moment of sale of the participation in the Swiss participation shall still be subject to the non-refundable higher withholding tax rate applicable to the seller instead of the possibly lower withholding tax rate applicable to the purchaser. As the withholding tax will only be levied once the purchased company distributes dividends, the practices applied by the Swiss tax administration may end up in costly surprises for a purchaser or a seller, as the case may be. When acquiring a Swiss company it is therefore recommended to check carefully whether or not one of the following pitfalls may apply and, if required, to obtain an advance tax ruling clarifying the exact tax consequences of an acquisition.

Indirect partial liquidation

Domestic indirect partial liquidation

Capital gains realised by a Swiss resident individual from the sale of shares in a Swiss company are, in principle, tax-free. However, if the conditions for a so-called indirect partial liquidation are fulfilled, then the tax free capital gain of the seller is requalified into a taxable dividend. For many years the indirect partial liquidation was a practice of the tax administration; today, it is explicitly provided for in the Swiss tax code and the Circular Letter No. 14 of November 6 2007. An indirect partial liquidation is assumed if the following conditions are fulfilled:

- At least 20% of a participation in a Swiss company (the target) is sold;
- In the hands of the seller the participation qualifies as private asset;
- In the hands of the purchaser the participation qualifies as business asset;
- Within five years of the acquisition date the target distributes assets not necessary for the running of business operations, which are distributable as dividends according to the commercial law regulations at the time of the acquisition; and
- The distribution is based on cooperation between the seller and the purchaser.

It is not only a formal distribution of existing distributable profits which triggers an indirect partial liquidation, but also any monetary benefit granted by the target (or its subsidiaries) to the purchaser to finance the purchase price of the target. Such monetary benefits may be, *inter alia*, loans or securities for third party loans. Also reorganisation measures may trigger the indirect partial liquidation if the reorganisation leads to the transfer of the existing distributable reserves from the target to the purchaser (for example, absorption of the target by the purchaser).

Because of the unknown income tax consequences for a Swiss resident seller (individual) resulting from a possible indirect partial liquidation, the seller will normally request from the Swiss or non-Swiss corporate purchaser in the share purchase agreement an indemnification for possible tax consequences during a five-year period following the acquisition. Due to its complexity, this condition normally causes difficulties in the course of the negotiations between the seller and the purchaser.

International indirect partial liquidation

Contrary to the domestic indirect partial liquidation, under which a tax-free capital gain of a Swiss resident is requalified into a taxable dividend, the Swiss tax administration has no tax jurisdiction over a non-Swiss seller. As a consequence, a requalification of a tax free capital gain into a taxable dividend would have no income tax consequences for a non-Swiss seller. However, the Swiss tax administration considers an international indirect partial liquidation under the aspect of the inherent, non-written tax treaty principle of tax avoidance. In doing so, a close connection to the tax avoidance provision under the Swiss withholding tax law seems to exist. Under Swiss withholding tax law, dividend distributions are, in principle, subject to a 35% withholding tax; taxpayers may request a refund if the correct declaration obligations are fulfilled. Under the Swiss withholding tax law a refund may, however, be denied if such refund results in tax avoidance. According to the long-lasting jurisprudence of the Swiss Federal Supreme Court, tax avoidance occurs if the following three conditions are cumulatively met:

- The legal structure used by the taxpayer is abnormal or artificial and has no commercial basis;
- Tax considerations are deemed to be the only motive for the transaction; and
- The transaction results in a significant tax benefit for the taxpayer.

It is recognised that the Swiss withholding tax law as domestic law cannot serve as a basis for the introduction of a tax avoidance clause in tax treaties. By the inherent assumption of an OECD-conforming, unwritten principle of tax avoidance underlying tax treaties, the required legal basis is justified with the aim of avoiding an unjustified withholding tax refund to a non-Swiss taxpayer. As a consequence hereof, the withholding tax refund right as previewed under a tax treaty may be limited or refused and a refund may (partial or fully) not be granted.

According to the interpretation of the Swiss tax administration, tax avoidance under the above described concept is also fulfilled if a taxpayer makes use of an intermediary to avail of a more beneficial withholding tax rate under a tax treaty concluded by Switzerland. The concept of international indirect partial liquidation refers to the concept of withholding tax avoidance by use of an intermediary to benefit from a better tax treaty rate. Under the international indirect partial liquidation a non-Swiss person not eligible, or only eligible to request a partial withholding tax refund under a Swiss tax treaty sells shares in a Swiss company, which disposes of distributable reserves, to a person qualifying for a lower withholding tax rate than the seller or for a full refund (Swiss purchaser) and the existing distributable profits of the target are used within the meaning of the concept of domestic indirect partial liquidation. If the Swiss tax administration assumes an international indirect partial liquidation, then distributable reserves existing at the moment of the transfer of the shares in the target from the seller to the purchaser will, when distributed at a later moment as dividend to the purchaser, not qualify for the withholding tax rate of the purchaser, but will be subject to the withholding tax rate applicable to the seller.

Example: A resident of Monaco, with which Switzerland has no tax treaty, sells his participation in a Swiss company (target) to a Swiss corporate investor. The target disposes of retained earnings, which are distributed after the purchase to the purchaser to finance the acquisition. While dividend distributions by the target to the Monacan shareholder would be subject to 35% Swiss withholding tax, the Swiss corporate investor does, in principle, not suffer any withholding tax consequences on the dividend received from Swiss subsidiaries. Under the theory of international indirect liquidation, however, such a transaction will be considered tax abusive and withholding tax of 35% will be levied on dividends (distributable profits at the moment of the purchase) distributed in the future from the Swiss subsidiary to its Swiss shareholder.

It should be noted that in the case of an international indirect liquidation no minimum threshold of 20% of transferred shares seems to exist for the Swiss tax administration as is the case for a domestic indirect partial liquidation; if the general conditions are fulfilled an international indirect partial liquidation is assumed even if a lower percentage of shares is transferred.

Transposition

Domestic transposition

Under the so-called principle of nominal value, every benefit received from a Swiss company in excess of the paid-in formal capital is, in principle, subject to income tax in the hands of the shareholder. Thus, dividends and liquidation proceeds paid by a company to its shareholder are subject to individual income tax. On the other hand a gain realised from the sale of shares in a company is tax-free for a Swiss resident individual. If an individual sells a participation (target) at a price exceeding the nominal value of the shares to a company owned by the same individual (purchasing company), then the individual could realise a tax free gain in the amount of the difference between the nominal value and the sales price and, as a consequence, would have avoided the taxation of dividends and liquidation proceeds. The purchasing company, on the other hand, could realise dividends and liquidation proceeds from the target tax-free by application of the participation exemption. As a consequence, the dividends and liquidation proceeds would not be taxed. To avoid such situation under the concept of transposition a tax-free capital gain is requalified into taxable income if a Swiss resident individual sells 5% or more of the capital in a Swiss company to a company in which he owns more than 50% of the capital, to the extent and in the amount the remuneration received from the sale exceeds the nominal value of the participation rights sold to the purchasing company.

International transposition

As under the concept of international indirect partial liquidation, the Swiss tax administration refers to the concept of tax avoidance when applying the theory of international transposition. A non-Swiss resident individual transfers participation rights in a Swiss company (target) to a Swiss parent company owned by the same shareholder at a value exceeding the nominal value of the transferred participation rights. The remuneration received by the individual for the transfer may, for example, be formal capital in the Swiss parent, cash or a loan claim. Such remuneration will no longer be subject to Swiss withholding tax. Before the transfer of the participation rights to the Swiss parent company, the non-Swiss individual would have been subject to withholding tax on dividends or liquidation proceeds distributed by the target (35% in case no treaty applies or at a reduced rate, normally 15% under treaties); under the post-acquisition structure the new Swiss parent company will, in principle, not suffer withholding tax consequences. The elimination or mitigation of the Swiss withholding tax burden is considered as tax avoidance; the Swiss tax administration will therefore 'freeze' for withholding tax purposes the distributable profits existing at the moment of the transfer of the participation and will levy on the future distribution of the frozen dividends withholding tax at the rate applicable to the selling individual at the moment of the transfer. The concept of international transposition will avoid the transformation of no or partial withholding refund rights into a full or more beneficial partial withholding refund right. In the case of an international transposition, neither the 5% or the 50% threshold, as applicable under the concept of a domestic transposition, seem to be relevant.

Rolf Wüthrich
burckhardt Ltd.

Mühlenberg 7
4010 Basel
Tel: +41 61 204 01 00
wuethrich@burckhardtlaw.com

Rolf is an international tax lawyer focusing his areas of expertise on domestic and international tax planning, inbound and outbound transactions, especially between the US and Switzerland, corporate restructuring and acquisitions as well as general corporate secretarial services.

burckhardt provides its clients and their businesses with comprehensive, tailored advice on national and international tax planning issues and structuring, offers corporate secretarial and notary service, supports clients with professional expertise and broad international experience on restructurings, mergers and acquisitions as well as joint ventures, corporate financing, advises on inbound and outbound investments and in all matters related to employment, trade and transport law as well as to private clients.

Theory of old reserves

Under the long-lasting practice of the 'theory of old reserves' a non-Swiss resident person transfers his participation rights in a Swiss company to another person (non-Swiss or Swiss resident). As a consequence of the transfer, the withholding tax rate applicable to future dividend distributions is reduced for one of the following reasons:

- Under the new ownership structure a tax treaty can be applied (under the old ownership structure no tax treaty could be applied); or
- Under the new ownership structure a different tax treaty with a lower withholding tax rate can be applied; or

- Under the new ownership structure a lower withholding tax rate applies according a tax treaty; or
- A total refund is possible under Swiss domestic law due to the fact that the participation was transferred to a Swiss parent company.

The withholding tax beneficial transfer of participation rights from a non-Swiss to a Swiss resident person with subsequent partial or full liquidation of the target company will be qualified as abusive by the Swiss tax administration and the administration will deny a refund of Swiss withholding taxes levied on the liquidation dividend.

In the case of a transfer of a participation from a non-Swiss to a Swiss or non-Swiss resident person without subsequent liquidation of the target, the Swiss tax administration will 'freeze' for withholding tax purposes the distributable profits existing at the moment of the transfer of the participation and will levy on the future distribution of the frozen dividends withholding tax at the rate applicable to the disposing person at the moment of the transfer.

Deemed liquidation

Mergers between Swiss companies can, subject to the fulfilment of certain requirements, occur in a tax-neutral manner, including withholding tax neutrality. However, tax neutrality is doubted by the Swiss tax administration if:

- the Swiss target company (target) is sold by a non-Swiss resident person;
- the transfer of the shares in the target from the seller to the purchaser results in a reduction of the applicable withholding tax rate; and
- the target is merged with the purchaser shortly after the acquisition.

The Swiss tax administration considers such a transaction as abusive for withholding tax purposes by arguing that the same economic result could, for example, have been reached by an asset deal instead of a share deal. An asset deal would have resulted in a total liquidation of the target and, as a consequence, to the respective withholding tax consequences. Under this theory of a deemed liquidation, the withholding tax rate applicable to the non-Swiss seller of the target is applied by the Swiss tax administration to the deemed liquidation proceeds of the target.

Transfer of a shell company

A shell company is considered to be a company which is in fact liquidated or which disposes mainly of liquid assets. A shell company normally shows one or more of the following characteristics:

- The company has closed down its business activity (production, trade, services, and so on); or
- The company has no assets or only assets in liquid form (cash, tradable securities, loans to shareholder, and so on); or
- After the transfer of the shell company's participation rights the name, the registered seat, the purpose and/or the board of directors of the company are normally changed.

In practice a transfer of a shell company is often picked up by the tax administration due to the corporate changes published in the commercial register (change of name, registered seat, purpose, board of directors, among others) or due to the characteristic pattern of the financial statements of a shell company. If the majority of the participation rights in a shell company are transferred, the tax administration assumes a liquidation of the shell company with subsequent establishment of a new company:

- On the level of the shell company, possible hidden reserves are realised and subject to corporate income tax;
- Losses carried forward: Under Swiss tax law losses can be carried forward for seven years following the period in which a loss was realised. In the case of a transfer of a shell company, the loss carry-forward will be denied and tax losses existing at the moment of the transfer cannot be set-off with future profits realised after the transfer;
- Withholding tax consequences: For withholding tax purposes, the company is deemed to be liquidated. On the deemed liquidation proceeds (normally equity minus contributed capital) withholding tax of 35% is due by the shell company. If the purchaser does not recapitalise the shell company then the set-off of commercial losses with future profits will be considered for withholding tax purposes as a capital contribution financed by the shell company and, as a consequence, a hidden dividend distribution to the shareholder subject to withholding (and income tax in case of Swiss shareholders) is due;
- On the level of the shareholder the liquidation gain will be subject to income tax (in the case of a corporate shareholder the participation exemption may apply);
- Stamp duties: The deemed subsequent establishment of a new company triggers a 1% stamp duty on the equity of the shell company (subject to the stamp duty exemptions); and
- Transfer tax: Should the selling or the acquiring entity qualify as a security dealer, that is, by disposing of securities in excess of CHF 10 million ($9.9 million), then security transfer tax of 0.15% of the price paid for the shell company will be due.

It should be noted that group internal treasury or cash management companies may, under certain circumstances, qualify as shell companies because cash and asset management activities are not in all cases recognised as an active business activity; due to the lack of business activity a transfer of such a treasury or asset management company can result in the refusal of a tax neutral reorganisation and, as a consequence, trigger the tax consequences of a shell company transfer.

International context and treaty interaction

In international situations, Switzerland assumes an inherent, non-written tax avoidance concept underlying the tax treaties. This inherent, non-written principle serves as justification to assume tax avoidance situations and to refuse the application of (lower) withholding tax rates under tax treaties and, as a consequence, to indirectly tax capital gains realised by a non-Swiss resident person by way of levying (higher) withholding taxes on dividend distributions of the sold Swiss company. This interpretation, supported by the Swiss Federal Supreme Court, was criticised in practice and by scholars in the past. It is the author's opinion that the practice applied by the Swiss tax administration results in an indirect treaty override as under the current practice capital gains realised by a non-Swiss person lead to a withholding tax punishment for the purchaser of the Swiss target company. Switzerland respects the allocation of the taxation right of capital gains realised from the sale of shares as defined in the applicable tax treaties; however, at the same time the transaction underlying the capital gain is considered tax abusive and serves as the basis to levy, on future distributions of frozen dividends, withholding taxes at a less beneficial rate. The applied practices leave taxpayers with the feeling that the goal of a tax treaty, the elimination or mitigation of direct and indirect double taxation, does not seem to be fulfilled, but rather bypassed. It would be interesting to know if the administration would agree to a lower withholding tax rate in an opposite case, that is, in the case where the final Swiss withholding tax rate is higher post-transaction than it was before the transaction. In theory one might be of the opinion that by consequent application of the inherent, non-written tax avoidance concept this should be the case.

burckhardt

Attorneys • Civil Law Notaries • Certified Tax Experts

focused

pragmatic

personal service

burckhardt Ltd
Mühlenberg 7 • PO Box 258 • CH-4010 Basel • Switzerland
Tel. +41 61 204 01 01 • Fax +41 61 204 01 09

info@burckhardtlaw.com
www.burckhardtlaw.com