Switzerland

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Business Tax Reform Act II Approved in Referendum – Measures and Entry into Force

On 23 March 2007, the Federal Parliament passed the Federal Act on the Improvement of Tax Law for Entrepreneurial Activity and Investments (Business Tax Reform Act II).[1] The draft act was subject to referendum. On 24 February 2008, the Swiss electorate approved the draft act, but voting was very close, with only 50.5% of the votes in favour. This note examines the new provisions contained in the draft act.

Introduction

The draft act introduces amendments to several federal tax acts, in particular, to the Federal Act on Stamp Duty (StG) of 27 June 1973, the Federal Act on the Federal Direct Tax (DBG) and the Federal Act on the Harmonization of Cantonal and Communal Direct Taxes (StHG) both of 14 December 1990, as well as the Federal Act on the Federal Withholding Tax (VStG) of 13 October 1965. The DBG covers individual and corporate income taxes as well as income taxation at source for individuals and legal entities. The StHG is a framework law that sets out detailed rules on individual income and net wealth taxes, corporate income and capital taxes, and income taxation at source for individuals and legal entities. The tax acts of the cantons must comply with the federal guidelines of the StHG. In accordance with the cantonal tax acts, the communes of each of the 26 cantons levy additional individual income and net wealth taxes and corporate income and capital taxes.

The general purpose of the draft act is the improvement of the tax law for small and medium-sized partnerships and companies and their owners. The primary issues covered are (1) the crediting of cantonal and communal corporate income tax against cantonal and communal corporate capital tax, (2) the improvement of the tax-free reorganization of sole proprietorships and partnerships, (3) the introduction of tax relief on the liquidation or sale of sole proprietorships and partnerships, (4) the improvement of the tax-free replacement of business assets, (5) the introduction of shareholder relief taxation for individuals, (6) the improvement of the participation relief for companies and cooperatives, (7) the improvement of the tax-free replacement of participations for companies and cooperatives, (8) the replacement of the principle of nominal value with principle of paid-in capital and (9) the improvement of tax-free reorganizations with regard to federal issuance stamp duty.

It is expected that the federal government will enact the amendments to the DBG, StHG and VStG with effect from 1 January 2009. The cantons have, however, been granted a transitional period of two years in which to adjust their cantonal tax law to the amendments of the StHG, except for the measure on the crediting of the corporate income tax against corporate capital tax, which should apply from 1 January 2009. The draft act also provides for a transitional period of two years for most of the amendments to the DBG and VStG.

Tax-Free Reorganization of a Business Operation

In general

New measures on the tax-free reorganization of a business operation are introduced in respect of federal, cantonal and communal individual income tax purposes. There is a transitional period of two years for federal, cantonal and communal income tax purposes.

Transfer of real estate

For Swiss federal individual income tax purposes, capital gains derived from immovable or movable property are tax free, provided that the taxpayer holds the property as private assets (*Privatvermögen*).[2] At cantonal and communal level, capital gains derived from movable property are tax free.[3] Capital gains derived from immovable property are, however, subject to cantonal and communal real estate capital gains tax. In this respect, Swiss cantonal and communal individual income tax is based on a schedular system with a separate capital gains tax schedule for real estate capital gains.

At federal level, there is only an income tax schedule, i.e. there is no separate capital gains tax schedule for real estate capital gains. Accordingly, capital gains derived from business assets (*Geschäftsvermögen*) are liable to federal individual or corporate income tax irrespective of whether or not they are derived from immovable or movable property. Most cantons also tax real estate cap-

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1. *Bundesgesetz über die Verbesserung der steuerlichen Rahmenbedingungen für unternehmerische Tätigkeiten und Investitionen (Unternehmenssteuerreformgesetz II) vom 23. März 2007*, AS 2005 1057.
2. Swiss tax law, however, provides for several recharacterization measures according to which a capital gain is deemed to be investment income (for example, interest from bonds with a pre-dominant one-off interest payment and an indirect partial liquidation on the sale of shares of a company), a capital gain from movable property is deemed to be a capital gain from immovable property (for example, the sale of the shares of a real estate company) or private income is deemed to be business income (for example, that of a professional securities dealer or a professional real estate dealer).
3. Id.

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ital gains derived from business assets by way of the cantonal and communal individual or corporate income tax (a dualistic taxation regime). In contrast, some cantons have extended the separate capital gains tax schedule to real estate capital gains derived from business assets (a monistic taxation regime).

A juridical doctrine has evolved according to which the transfer of property from business to private assets is treated to be a deemed sale (*Privatentnahme*) for federal, cantonal and communal income tax purposes. With regard to the transfer of immovable property where the *situs* canton has adopted the dualistic taxation regime, the difference between the fair market value and the tax base of the immovable property is subject to income tax (income from recaptured former deprecation and accrued real estate capital gains). If, however, the *situs* canton has adopted a monistic taxation regime, only the difference between the investment cost and the tax base (income from recaptured former deprecation) is subject to income tax. The taxation of capital gains is deferred until a subsequent sale to a third party.

The draft act introduces a partial tax-free transfer of immovable property from business to private assets, which avoids the taxation of accrued real estate capital gains, provided that the taxpayer holds the immovable property as a fixed business asset.[4] This measure is relevant for federal, cantonal and communal individual income tax purposes if the *situs* canton has adopted the dualistic taxation regime. Under this measure, the taxpayer is entitled to limit taxation to income from recaptured former deprecation, i.e. taxation of the difference between the investment cost and the tax base. The taxation of the accrued capital gains equal to the difference between the fair market value and the adjusted tax base (i.e. the investment cost) is, however, deferred until the immovable property is sold to a third party. This measure is not relevant for cantonal and communal income tax purposes if the *situs* canton has adopted a monistic taxation regime, as the transfer of immovable property from business to private assets does not give rise to real estate capital gains tax.

Lease of a business operation

According to juridical doctrine, the definite lease of a business operation to a third party is treated as a taxable transfer from business to private assets (*Privatentnahme*). The draft act, however, abolishes this doctrine insofar as it treats the lease of a business operation as a taxable event only at the taxpayer's request.[5]

Partition of inheritance

If a community amongst heirs is divided and not all of the heirs continue the business operation of the deceased, the other heirs generally realize taxable liquidation income from business assets. If the deceased also held immovable property as a business asset, the division gives rise to federal, cantonal and communal individual income taxes on the difference between the fair market value and the tax base. If the *situs* canton has adopted, however, a monistic taxation regime, income from recaptured former deprecation is taxed, but the taxation of accrued capital gain is deferred.

The draft act introduces a tax-free transfer of immovable property amongst heirs. This measure is relevant to both dualistic and monistic taxation regimes. If the *situs* canton has adopted a dualistic taxation regime, the taxpayer is not only entitled to avoid the taxation of income from recaptured former deprecation, but also the taxation of accrued real estate capital gains.

The draft act imports the principle of a carry-over basis from the real estate capital gains taxation regime into the income taxation system. The heirs who continue the business operation of the deceased are entitled to request the deferral of the taxation of taxable liquidation income insofar as they carry over the tax base for income tax purposes of the business operation (including immovable property).[6]

Tax Relief for Liquidation of a Business

New measures on relief for taxation of liquidation or sale of a business are introduced in respect of federal, cantonal and communal individual income tax purposes. For federal, cantonal and communal income tax purposes, there is a transitional period of two years.

Swiss individual income tax rates are structured in progressive tax brackets. If a taxpayer liquidates or sells a business, taxable liquidation income is realized from business assets. The draft act mitigates progression by introducing a preferential tax treatment for the liquidation income, including income from recaptured former deprecation. If a self-employment activity, either a sole proprietorship or partnership, is definitely liquidated or sold to a third party by an individual who has reached the age of 55 or who is unable to continue the business due to invalidity, the liquidation income realized during the last two business years is taxed separately from other income.[7] This measure also applies to the surviving spouse, the other heirs and legatees if they do not continue the business of the deceased.

For federal and, if the *situs* canton has adopted a dualistic taxation regime, also for cantonal and communal individual income tax purposes, this measure also avoids the progressive taxation of real estate capital gains. This is because real estate capital gains are also included in taxable liquidation income.

Tax-Free Replacement of Business Assets

These measures are introduced for federal, cantonal and communal individual and corporate income tax purposes with a transitional period of two years. Specifically, an individual or legal entity is entitled to carry over

4. Art. 18(a)(1) DBG, as amended, and Art. 8(2bis) StHG, as amended.
5. Art. 18(a)(2) DBG, as amended, and Art. 8(2ter) StHG, as amended.
6. Art. 18(a)(3) DBG, as amended, and Art. 8(2quater) StHG, as amended.
7. Art. 37(b) DBG, as amended, and Art. 11(5) StHG, as amended.

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the tax base of a fixed asset necessary for the business to a replacement asset, provided that it has the same function. The carry-over of the tax base to an asset outside Switzerland is not tax free.

The draft act no longer requires the same function in respect of the replacement asset.[8] The Federal Parliament has, however, not adopted a pure reinvestment doctrine. Instead, the replacement asset must still qualify as a fixed asset necessary for the business. The draft act also excludes the replacement of immovable through movable property.

Shareholder Relief Taxation for Individuals

In general

In order to avoid economic double taxation of business profits and, in particular, to harmonize the different shareholder taxation regimes that have been implemented by most cantons over the previous years, measures on shareholder relief taxation are introduced for federal, cantonal and communal individual income tax purposes. It is expected that these will be enacted to have effect from 1 January 2009 for federal income tax purposes.

Federal income tax

Swiss income tax law is traditionally based on the concept of the economic double taxation of distributed business profits (a classical system). Business income of a sole proprietorship or a partnership is subject to income taxation and includes dividends and capital gains derived from domestic and foreign participations. In contrast, if the taxpayer holds the participations as private assets, dividend income is subject to income tax, but capital gains are tax free.[9]

The draft act introduces a shareholder relief taxation regime according to which part of the dividend is exempt from the tax base. For business income purpose, only 50% of dividends and capital gains derived from participations in domestic and foreign companies (corporations and limited liability companies) and cooperatives is subject to federal individual income tax, provided that the participation reflects an interest of at least 10% in capital of a company or cooperative.[10] Capital gains relief also requires a holding period of at least one year.[11] In contrast, for private assets, only 60% of the dividend derived from participations in domestic and foreign companies and cooperatives is subject to federal individual income tax, provided that the participation reflects an interest of at least 10% in capital of a company or cooperative.[12]

Cantonal and communal income taxes

Most cantons, in particular the German speaking ones, have already implemented individual shareholder relief taxation regimes for dividend income derived from domestic participations held as private assets. The minimum holding requirement varies between 5% and 20%. Some cantons require a minimum fair market value of between CHF 2 million and CHF 5 million. One canton also requires a one-year holding period. A few cantons grant shareholder relief taxation for participations in foreign companies. Almost all cantons have introduced shareholder relief taxation at the level of the tax rate rather than at the level of the tax base.

The draft act grants discretion to the cantons to introduce individual shareholder relief taxation for dividends derived from participations in domestic and foreign companies and cooperatives.[13] The cantons have been given a transitional period of two years. The draft act also provides for the requirement that the participation reflects an interest of at least 10% in the capital of a company or cooperative. The 10% minimum holding requirement was one of the most controversial subjects before the referendum. It was argued that the requirement was arbitrary and did not comply with the constitutional principle of equal treatment. The draft act is technically structured as a measure at the level of the tax base. As shareholder relief taxation may be understood as a measure at the level of the tax base or at the level of the tax rate and as the income tax rates are set by the cantons, this does not take account of a particular percentage with regard to how much of the dividends are exempt from the tax base. It appears that this measure only applies to participations held as private assets.[14] Accordingly, it appears that the cantons are free to introduce individual shareholder relief taxation regimes for participations held as business assets.

The question, therefore, arises as to whether or not the cantons must adjust their existing shareholder relief taxation regimes to the draft act. In the author's view, it is for the cantons to decide whether they introduce shareholder relief taxation regime either at the level of the tax base or the tax rate. The cantons must, however, adopt the 10% minimum holding requirement and must apply the shareholder relief to both participations in domestic and foreign participations. Additional requirements, such as a minimum holding period, do not comply with the draft act.

Participation Relief for Companies and Cooperatives

An improvement of the participation relief is introduced for federal, cantonal and communal corporate income tax purposes with a transitional period of two years. It should be noted that it is for the cantons to decide whether or not they introduce participation relief not only for dividends, but also for capital gains.

8. Art. 30(1) and Art. 64(1) DBG, as amended, and Art. 8(4) and Art. 24(4) StHG, as amended.
9. See, however, the recharacterization of capital gains as dividend income: Peter Reinarz and Marcel R. Jung, "Indirect Partial Liquidation: New Tax Rules", *Derivatives & Financial Instruments* 1 (2008), p. 24 et seq.
10. Art. 18(b)(1) DBG, as amended.
11. Art. 18(b)(2) DBG, as amended.
12. Art. 20(1bis) DBG, as amended.
13. Art. 7(1) StHG, as amended.
14. See also the protocols of the proceedings of the Council of States (*Ständerat*), 13 June 2006, Official Journal 2006, p. 437 et seq.

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At the level of Swiss companies (corporations, partnerships limited by shares and limited liability companies) and cooperatives, Swiss income tax law avoids or mitigates economic multiple taxation of business profits by virtue of the participation relief. This is aimed at the tax liability rather than the tax base. Dividends and capital gains derived from participations in domestic and foreign companies and cooperatives are included in the tax base, but the corporate tax liability is reduced by the ratio of the net participation income to the entire net income.

Dividend relief requires an interest of at least 20% in capital or in interest with a fair market value of at least CHF 2 million of another company or cooperative. In contrast, capital gains relief requires that the sold participation reflects an interest of at least 20% in the capital of another company or cooperative and fulfils a holding period of at least one year. For the purpose of the 20% minimum holding test, staggered sales during the same business year are aggregated, provided that these are based on the same business decision.

The draft act reduces these thresholds and introduces alternative tests.[15] Dividend relief requires an interest of at least 10% in capital or of at least 10% in the profits and reserves, or an interest with a fair market value of at least CHF 1 million of another company or cooperative. In contrast, capital gains relief requires that the sold participation reflects an interest of at least 10% in capital or of at least 10% in the profits and reserves of another company or cooperative, and, additionally, a minimum holding period of at least one year. Accordingly, the application of the participation relief is no longer limited to shareholders. Instead, the contractual entitlement to profits and reserves, such as that that could be provided for by jouissance rights (*Genussscheine*), may also fall into the scope of the participation relief.

For the purpose of the 10% minimum holding test, the draft act no longer requires that staggered sales fall into the same business year. Instead, the taxpayer may sell a participation through staggered packages in more than one business year, each of less than 10%, provided that the participation fulfilled at the beginning the 10% minimum holding test and, additionally, that the participation had a fair market value of CHF 1 million at the end of the tax year prior to the year of the subsequent sales. The following example illustrates this.

Example

SwissCo has held a participation of 10% in the capital of ForeignCo for a long time. In year 1, SwissCo sells 7% and, in year 2, the residual package of 3%. In both years, SwissCo realizes capital gains. SwissCo is entitled to participation relief in year 1. In year 2, however, SwissCo is entitled to participation relief only if the fair market value of the 3% package at the end of year 1 was at least CHF 1 million.

Tax-Free Replacement of Participations

In accordance with the enhancement of participation relief, the draft act improves the measures on the tax-free replacement of participations for federal, cantonal and communal corporate income tax purposes. There is a transitional period of two years for federal income tax purposes.

A Swiss company (corporations, partnerships limited by shares, and limited liability companies) or cooperative is entitled to carry over the tax base of a participation in another company or cooperative to a replacement participation, provided that the sold participation reflects an interest of at least 20% in the capital and was held for at least one year. The draft act takes account of the amended requirements of the participation relief and, therefore, reduces the minimum holding requirement to 10% and inserts an alternative test according to which the sold participation may also reflect an interest of at least 10% in the profits and reserves of the company or cooperative.[16]

Principle of Paid-In Capital

The draft act replaces the previous principle of nominal value for federal, cantonal and communal individual income tax purposes as well as for federal withholding tax purposes. As there is a transitional period of two years for federal income and withholding tax purposes, it is expected that this measure will be enacted to have effect from 1 January 2011 for federal income and withholding tax as well as for cantonal and communal income tax purposes.

For federal individual income tax purposes, taxable investment income from participations in domestic and foreign companies includes all proceeds paid by the company in excess of the nominal value of the participation if the taxpayer holds the participation as a private asset (*Nennwertprinzip*). Similarly, for federal withholding tax purposes, taxable investment income from participations in domestic companies includes all proceeds paid by the company in excess of the nominal value that is subject to federal withholding tax at a statutory rate of 35%. For example, the repayment of paid-in share premium by a Swiss company is subject to federal withholding tax and, if the taxpayer is Swiss resident and holds the participation as private assets, also to federal income tax. Almost all cantons have also adopted the principle of nominal value for cantonal and communal individual income tax purposes.

The draft act introduces the new principle of paid-in capital (*Kapitaleinlageprinzip*).[17] Under this principle, the repayment of investments, paid-in surplus and contributions are treated in a similar way to the repayment of nominal capital, provided that they were paid to the company by a shareholder after 31 December 1996. This means that the repayment of paid-in share premium is no longer subject to federal withholding tax and, if the

15. Art. 69 and Art. 70(4)(b) DBG, as amended, and Art. 28(1) and Art. 28(1bis) StHG, as amended.
16. Art. 64(1bis) DBG, as amended, and Art. 24(4bis) StHG, as amended.
17. Art. 20(3) DBG, as amended, Art. 7(b) StHG, as amended, and Art, 5(1bis) VStG, as amended.

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shareholder is Swiss resident and holds the participation as private assets, is also free of federal, cantonal and communal income taxes.

Federal Stamp Duty

CHF 1 million exemption threshold

The issuing of participations by Swiss companies (corporations, partnerships limited by shares and limited liability companies) and cooperatives is subject to Swiss federal stamp duty at a rate of 1%. The creation or the increase of the nominal value of the participation is also subject to stamp duty. In addition, contributions that do not increase the nominal capital (for example, paid-in share premiums) are treated as the creation of nominal value and, therefore, are also subject to stamp duty. The law contains a long list of exceptions.

Under the draft act, the creation or increase of nominal value of participations in cooperatives is exempt up to an initial amount of CHF 1 million.[18] The draft act adjusts the threshold for cooperatives to comply with that for Swiss companies.

Tax-free financial reorganizations

The draft act introduces two new exemptions for financial reorganizations. The first exemption applies to special purpose companies (*Auffanggesellschaften*). The creation or increase of nominal value of participations in Swiss companies and cooperatives in connection with the acquisition of a branch of activity (*Betrieb* or *Teilbetrieb*) of another company (corporations, partnerships limited by shares and limited liability companies) or cooperative is exempt if, according to the last annual balance sheet of the other company or cooperative, half of the share capital and the legal reserves are no longer covered.[19]

In these circumstances, the draft act exempts (1) the creation or the increase of the nominal value of participations in companies and cooperatives up to the amount that existed before the financial reorganization (a disclosed financial reorganization) and (2) contributions by shareholders and members (an undisclosed financial reorganization). This is provided that all the loss carry-forwards are eliminated and the payments of shareholders and members do not exceed CHF 10 million in total.[20]

18. Art. 6(1)(b) StG, as amended. The current threshold is CHF 50,000.
19. Art. 6(1)(j) StG, as amended. This new measure is linked to Art. 725(1) of the Federal Code of Obligation of 30 March 1911, according to which the board of directors must without delay call a general meeting of shareholders and propose financial reorganization if the last annual balance sheet shows that half of the share capital and the legal reserves are no longer covered.
20. Art. 6(1)(k) StG, as amended.

BOOK

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