Switzerland

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Indirect Partial Liquidation: New Tax Rules

This article will address the interpretation of the Swiss tax authorities with regard to the new statutory rules on indirect partial liquidations pursuant to Circular 14. This Circular was issued in response to an unfavourable Federal Tribunal ruling of 11 June 2004, which held that the potential scope of the indirect partial liquidation was not limited to the retained earnings of the target company as of the date of the sale of its shares, but could also extend to distributions by the target company to the acquiring company of profits earned only after the sale of the shares had occurred.

1. Introduction

The Swiss merger and acquisition (M&A) market for companies privately held by resident individuals significantly stagnated between 2004 and 2006 because of an unfavourable Federal Tribunal ruling of 11 June 2004 with regard to the indirect partial liquidation doctrine.[1] The base case of the doctrine features a private shareholder who sells shares of a "cash-rich" company (the target company) to a "poor" buyer which is a business, whereby the buyer deprives the target company of its cash reserves (typically through a dividend) within five years after the sale in collusion with the seller in order to finance or refinance the share purchase price.

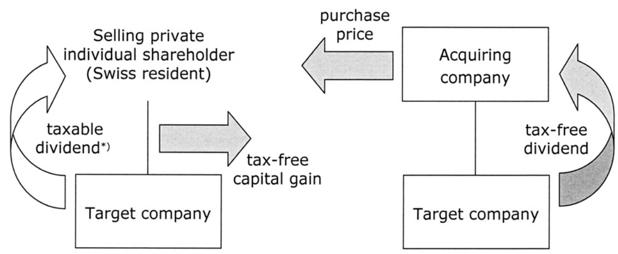
The indirect partial liquidation doctrine deconstructs the share purchase price into a "normal" price and an overpayment.[2] The overpayment is recharacterized as a taxable liquidation dividend, which is deemed to be distributed by the target company *to the selling shareholder*. Available funds of the target company are indirectly made available to the selling shareholder under form of the payment of an overpayment by the acquiring company, which finances or refinances such payment through a subsequent dividend from the target company. Unlike the selling shareholder, the acquiring company will not suffer any relevant Swiss income tax burden on the dividend, as it may either claim participation relief or take a depreciation of the shares against the dividend received. The dividend is regarded as a partial liquidation, which *indirectly* benefits the previous, selling shareholder.

In the above-mentioned, widely criticized 2004 ruling, the Federal Tribunal held that the potential scope of the indirect partial liquidation was not limited to the retained earnings of the target company as of the date of the sale of its shares, but could also extend to distributions by the target company to the acquiring company of profits earned only after the sale of the shares had occurred. The Federal Tribunal construed such a distribution of post-sale profits as an "extraction of funds" designed to refinance the payment of the share purchase price to the previous, selling shareholder. This new, tightened practice in fact blocked many private M&A deals. Private individuals could practically only sell their companies to "rich" acquirers that could finance the entire transaction from their equity capital, or were able to service their acquisition-related debt from other sources.

On 15 November 2006, the federal government enacted the Federal Act of 23 June 2006 on Urgent Amendments to Enterprise Taxation with effect from 1 January 2007.[3] This Federal Act amends both the Federal Act of 14 December 1990 on the Federal Direct Tax (DBG) and the Federal Act of 14 December 1990 on the Harmonization of Income Taxes of Cantons and Communes (StHG).[4] The StHG is a framework law providing for detailed rules on individual and corporate income taxation, and cantonal tax laws must be in line with the StHG. The Federal Act of 23 June 2006 has also harmonized the rules on the indirect partial liquidation doctrine.[5]

The new law has superseded the Federal Tribunal ruling that allowed the application of the indirect partial liquidation doctrine to the distribution of post-acquisition profits of the target company to the acquiring company. Under the new law, only the retained earnings of the target company as of the date of the sale of the shares may be affected by the indirect partial liquidation tax consequences.

Figure 1: Indirect partial liquidation doctrine



*) In contrast to the federal level, most cantons have recently introduced shareholder relief taxation.

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1. Federal Tribunal, 11 June 2004, *Eidg. Steuerverwaltung v. Eheleute A. und B. X.*, 2A.331/2003.
2. See Peter Böckli, "Kritik der 'indirekten Teilliquidation': Von der Zerlegungsmethode zur Mittelherkunftssteuer", in Markus Reich and Martin Zweifel (eds.), *Das Schweizerische Steuerrecht: Festschrift zum 70. Geburtstag von Ferdinand Zuppinger* (Berne: Stampfli, 1989), at 103 et seq. and 116.
3. AS 2006 4883 4885; Federal Journal 2005 4733. See Marcel R. Jung, "Switzerland: 2006 Year in Review", *Tax Notes International* (25 December 2006), at 1110.
4. Federal Act of 14 December 1990 on the Federal Direct Tax (DBG), SR 642.11; Federal Act of 14 December 1990 on the Harmonization of Income Taxes of Cantons and Communes (StHG), SR 642.14.
5. Art. 20a(1)(a) DBG and Art. 7a(1)(a) StHG.

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The new rules came into effect on 1 January 2007 for federal income tax purposes and will become effective as from 1 January 2008 for cantonal and communal income tax purposes. At the federal tax level, the new rules are applicable to all cases of indirect partial liquidation starting from the fiscal year 2001 to the extent that the income tax assessments are not yet final.

The final administrative guidance on indirect partial liquidations was published by the Federal Tax Administration (FTA) on 6 November 2007 (Circular 14). This article will address the FTA interpretation of the new statutory rules on indirect partial liquidation pursuant to Circular 14.

2. Origin of the Indirect Partial Liquidation Doctrine

2.1. "Dualistic" income tax regime

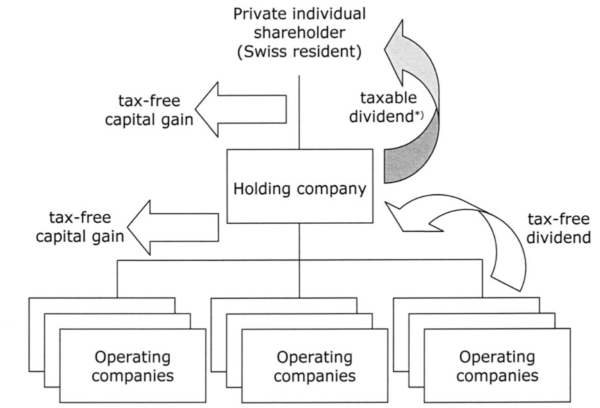
The income tax system is based on the classical system of double taxation of distributed profits, i.e. corporate profits are taxed at the corporate level and, when distributed to individual shareholders, again at the individual level.[6] The previous Federal Decree of 9 December 1940 on the Federal Direct Tax (BdBSt) provided for a dualistic regime of income taxation in the hands of private individuals. While income from capital, such as dividends and interest, was fully taxable,[7] capital gains realized by private individuals on movable assets including equity and debt securities were tax free.[8] This dualistic system has, in principle, survived until today.

2.2. The nominal value principle

A further important tax feature of the previous BdBSt, which also has survived until today and which was first established under the previous Federal Act of 25 June 1921 on Stamp Duty on Coupons (CG), is the so-called nominal value principle.[9] For federal withholding tax and income tax purposes of private individuals, taxable investment income from equity and debt securities includes all proceeds paid by the issuer to the private individual investor in excess of the nominal value of the instrument.[10] Thus, for example the repayment of paid-in share premium to a private individual shareholder is taxable.[11] The nominal value principle applies to equity and debt securities held by individuals as private assets, regardless of the acquisition cost incurred by the individual.[12]

The dualistic income tax regime and the nominal value principle for private individuals found their way into the DBG and the StHG, and thus also into the tax laws of the cantons. At the federal level, capital gains derived from movable and immovable assets by individuals who hold the assets as private (non-business) property are tax free.[13] At the cantonal and communal level, the same rule applies to capital gains derived from movable private assets only.[14] The nominal value principle in turn found its way into the DBG and also into the tax laws of most cantons.[15] In contrast to the dualistic income tax regime at the private individual level, capital gains and dividend income realized by corporate shareholders on qualifying Swiss and non-Swiss participations are relieved from taxation through the participation relief mechanism in order to avoid multiple taxation of corporate profits.[16]

Figure 2: Dualism of individual income taxation



*) In contrast to the federal level, most cantons have recently introduced shareholder relief taxation.

In summary, a private individual shareholder who realizes value from his or her shareholding through the receipt of dividends is taxed, while such person is in principle not taxed if he or she realizes the value through a sale of the shares. The new statutory rules on indirect partial liquidation principally confirm this general rule. The new law, in conjunction with the new Circular 14, clarifies the conditions under which the tax authorities are to deviate from the general principle and impose income tax upon a private individual selling shareholder with regard to a deemed dividend income from indirect partial liquidation of the target company.

Essential elements of the previous practice of the tax authorities and the courts, which had evolved and developed over the past 30 years without any solid basis in the

6. However, Switzerland is at the stage of switching over to a shareholder relief system. During recent years, an increasing number of Swiss cantons, in particular the German-speaking cantons, have introduced a shareholder relief tax regime with regard to dividends received by an individual shareholder on qualifying participations in Swiss companies who holds the qualifying participation as a private asset.
7. Art. 21(1)(c) BdBSt.
8. Art. 21(1)(d) *e contrario* BdBSt.
9. Art. 5(2) CG; Art. 21(1)(c) BdBSt.
10. Art. 14(1) and Art. 20(1) Federal Ordinance of 19 December 1966 on the Withholding Tax (VStV); Art. 20(1)(c) DBG.
11. The most recent business tax reform is set to abolish the nominal value principle in regard to equity funds (such as share premium) contributed to the company by the shareholders. This reform would also introduce a shareholder relief system at the federal level that takes account of qualifying participation held as private or business assets. However, this reform is still subject to a referendum, which will be held on 24 February 2008.
12. For example: cost base = 1,000; nominal value = 200, net liquidation proceeds = 700; individual's loss = 300. This results in taxable investment income of 500.
13. Art. 16(3) DBG. Accrued interest realized on the sale of a bond with a predominant one-time interest payment (*intérêt unique prédominant*, IUP) is treated as taxable investment income. See Art. 20(1)(b) DBG.
14. Art. 7(4)(b) StHG. The economic transfer of title with regard to Swiss real estate, as well as the transfer of shares in a Swiss real estate company, may trigger cantonal and communal real estate capital gains tax. See Art. 12(2)(a) and (d) StHG.
15. Art. 20(1)(c) DBG.
16. Art. 69 and 70 DBG and Art. 28(1bis) and (2) StHG.

tax laws and was therefore criticized by many Swiss tax scholars, are now codified in the new tax rules.[17] The new tax rules are a reaction by the Federal Parliament to the over-reaching Federal Tribunal ruling of 11 June 2004.

3. Features of the New Tax Rules

3.1. Overview

Under the new rules,[18] a Swiss tax resident individual (the "selling shareholder") will be taxed on an indirect partial liquidation dividend upon the sale (or exchange against valuable remuneration) of privately held shares, if all of the following conditions are cumulatively met:
– the selling shareholder held an interest of at least 20% in the capital of the Swiss or foreign target company;
– the shares were held as private (non-business) property and are sold into the business property of a resident or non-resident, unrelated acquirer (typically a company);
– as of the date of the sale, the target company has non-operational assets (e.g. cash, securities, real estate held for investment purposes, etc.) which the target company could have distributed to the private seller as a dividend prior to the share sale without violating company law;
– within five years of the share sale, the target company makes a distribution of substance (non-operating assets which would have been available for distribution under company law at or before the date of the share sale) to the acquirer; and
– the selling shareholder has cooperated with the acquirer with regard to that distribution of substance.

3.2. Requirements

3.2.1. Sale or exchange

Only the sale or exchange of a participation to a third party for valuable remuneration is subject to tax. If, after the transfer, the acquiring company holds at least 50% of the voting rights of the target company, and the consideration paid by the acquiring company to the selling shareholder consists primarily of shares in the acquiring company of at least 50% of the value of the transferred participation, an overlap between a taxable indirect partial liquidation and a tax-neutral exchange of shares (quasi-merger) may occur.[19] In the authors' view, the tax-neutral rule prevails. However, the absorption of the target company by the acquiring company within five years may trigger a taxable merger at the level of the selling shareholder with retrospective effect.

3.2.2. Qualifying participation

The transaction must encompass a participation of at least 20% in the capital of the target company. The target company may be a corporation or a cooperative, and a Swiss or non-Swiss company.

If the selling shareholder sells the participation on a staggered basis and held a qualifying participation at the time of the first sale, staggered sales occurring within a five-year period are added together. Furthermore, parallel sales by different selling shareholders are aggregated if they are based on a joint decision. No joint decision is assumed where minority shareholders merely accept a public tender offer under Art. 22-33 of the Federal Act of 24 March 1995 on Securities Law (BEHG). If a joint sale is structured in a staggered manner, all sales within a five-year period are aggregated.

3.2.3. Change of tax regime

The shares of the target company must be sold from the private (non-business) property of a resident individual shareholder into the business property of a resident or non-resident individual (e.g. sole proprietorship or partnership) or corporate acquirer. This means a change from the nominal value principle to the book value principle.

3.2.4. Distribution

3.2.4.1. Distribution from "Substance"

The Circular requires that the distribution must be an extraction of substance from the target company. In light of the Federal Tribunal ruling of 11 June 2004 from which a distinction between distribution from existing retained earnings and distribution from future profits evolved,[20] in the authors' view this requirement must be construed to mean that the distribution must not be a substantial distribution as such, but a distribution from retained earnings existing as of the date of the share sale. This interpretation is supported by the Circular itself, where it expressly clarifies that any dividends made from the ordinary annual net profits of the target company which arise as from the year of the share sale are regarded as ordinary distributions rather than distributions of substance. This also includes the distribution of reserves built from such post-acquisition profits, unless those reserves were absorbed by net losses accrued after the share sale. Any distributions that are not covered under the notion of ordinary distributions are regarded as substance distributions.

3.2.4.2. Forms of distribution

In addition, the Circular clarifies that the notion of distribution is not limited to open dividends that are formally declared by the shareholders' meeting of the target company. Rather, the term "distribution" also includes any disguised profit distributions and other benefits of

17. See Böckli, note 2.
18. See Art. 20a(1)(a) DBG and Art. 7a(1)(a) StHG.
19. See Circular 5 of 1 June 2004 on Reorganizations, published by the Federal Tax Administration, Paras. 4.1.1.14 and 4.1.7.
20. See Draft Circular 7 of 14 February 2005 on the Transfers of Participations from Private Assets to Business Assets, published by the Federal Tax Administration.

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monetary value made by the target company to the acquirer or the shareholders of the acquirer, including:
- dividends in kind;
- non-arm's length loans granted by the target company or its controlled subsidiaries to the acquirer, if the loan repayment appears to be jeopardized and has the effect of diminishing the net assets of the target company; and
- debt collateral provided by the target company or its controlled subsidiaries in favour of the acquirer, if the realization of the collateral appears to be likely so that the collateralization causes a diminishing of the net assets of the target company.

The Circular mentions that certain types of corporate restructuring may lead to the effect of monetary benefits in favour of the acquirer (e.g. absorption of the target company by the acquiring company).

3.2.4.3. Non-operating assets

The Circular also requires that the distribution must be a distribution from non-operating assets. The analysis of non-operating assets is made as of the agreed transfer date of the share sale on the basis of economic criteria. It is possible to stipulate that the transfer date will be deemed to be the date of the latest statutory, single-entity commercial balance sheet of the target company.

The analysis extends to the assets directly held by the target company, as well as the assets held via any subsidiary companies that are under the common control of the target company in accordance with Art. 61(3) of the DBG. Common control is assumed if the parent company owns more than 50% of the voting rights in the subsidiary company.[21] All those subsidiary companies are tested in the same manner as the target company itself. The Circular establishes an assumption of fact (which presumably may be rebutted) that any distributions which exceed the amount of profits generated since the sale of the target company shares are distributed from non-operating assets. The non-operating assets (other than cash) must be valued in accordance with generally accepted valuation principles. Liabilities associated with such assets are deducted and the contingent taxes on the hidden reserves are taken into account. The Circular suggests that the valuation is to occur only if and when a substance distribution actually takes place prior to the five-year deadline.

The analysis of the non-operating assets and the distributable reserves is made on the assumption of unchanged continuation of the business activity of the target company after the share sale; any changes of the business operation after the purchase by the acquirer are irrelevant for the analysis.

3.2.4.4. Distributable reserves

The distributable reserves are determined on the basis of the statutory commercial balance sheet (single entity accounts) of the last accounting period ended prior to the date of the share sale. The starting point of the calculation is the total net equity position of the target company. Deductions are to be made for the nominal share capital and the maximum possible amount of legal reserves under Swiss company law or similar provisions of foreign company law, as the case may be.[22]

3.2.5. Five-year period

The distribution from the target company to the acquiring company must occur within five years after the signing of the share purchase agreement. The five-year blocking period generally runs from the date of the share purchase agreement, unless the completion of the acquirer's payment obligation must be regarded as uncertain. In the event of a staggered sale of a qualifying participation, the five-year period is calculated separately for each sale portion.

3.2.6. Cooperation

The Circular states that the cooperation criterion may be judged only in connection with an actual distribution, and concludes that prior to such distribution, the cooperation criterion cannot be excluded at the outset.

The Circular makes reference to the extensive Federal Tribunal jurisprudence on the cooperation requirement. Generally, cooperation is assumed, according to the Circular, when the seller knows, or should know under the circumstances, that substance (non-operating assets that would have been available for distribution at the time of the share sale) will be extracted from the target company in order to be paid to the selling shareholder under form of share sale proceeds (the overpayment). Such is the case, according to the Circular, when the acquiring company funds the purchase price payment through an extraction of substance (through an open or disguised dividend) from the target company, or if it refinances the original debt or equity (!) financing of the purchase price through such an extraction of substance. Based on earlier Federal Tribunal rulings, the Circular proposes that the presence of cooperation between the parties in view of an indirect partial liquidation of the target company be considered in view of the overall facts and circumstances regarding the funding of the purchase price payment.

The Circular distinguishes between active and passive forms of cooperation of the selling shareholder. Examples for active cooperation include:
- funding loans by the seller to the acquiring company;
- setting-off of debts of the selling shareholder towards the target company against the purchase price claim;

21. See Circular 5 of 1 June 2004 on Reorganizations, published by the Federal Tax Administration, Para. 4.5.2.3.
22. See Art. 671, 671a and 671b OR for corporations and Arts. 805 and 860 OR for limited liability companies and cooperatives of the Swiss Code of Obligations of 30 March 1911.

- the granting of debt collateral by the target company to secure third-party loans used for the transaction funding at the time of the sale transaction;
- the granting of the shares of the target company by the seller as collateral for the debt funding of the acquirer;
- any undertaking by the selling shareholder to liquidate assets of the target company; and
- the transfer of actual control over the assets of the target company to the acquiring company prior to the payment of the share purchase price, etc.

Passive forms of cooperation address the situation where it must be assumed as a fact that the selling shareholder is aware (or should be aware) of an extraction of substance occurring to fund the purchase price payment. The Circular mentions the following examples:

- the selling shareholder sells the shares to a "poor" business property acquiring company which does not have the means available to fund the purchase price from its own financial resources or from future ordinary distributions from the target company; and
- the selling shareholder is aware of the intention of the acquiring company to merge with the target company.

The Circular suggests, by making reference to a Federal Tribunal ruling of 9 July 1996,[23] that even the lack of the selling shareholder's knowledge of the acquiring company's intention to merge does not necessarily mean that he or she has not cooperated with the acquiring company, "if the seller had to take into account that the funds extracted from the target company with his cooperation would not be returned again to the target company". The underlying facts of the case involved a private seller who had undertaken towards the acquiring company to sell off and liquidate certain assets of the target company prior to completion of the share sale as a condition precedent for the payment of a first tranche of the share purchase price. A few days after the transfer of the shares against payment of the first part of the purchase price, the target company granted the acquiring company a substantial loan, which was later settled by means of an absorption merger of the target company into the acquiring company. The Federal Tribunal substantially held that, based on his undertaking to liquidate assets of the target company, the selling shareholder had to take into account the likelihood that the cash proceeds from such liquidation would eventually be used for distribution to the acquiring company and hence to refinance some of the share purchase price payment, regardless of whether the selling shareholder knew about the later dissolution through merger of the target company.

3.3. Calculation of taxable amount

In the event that within the five-year period following the sale of the shares any substance distributions from the target company occur and all other conditions (in particular, cooperation by the seller) are met, a portion of the sale proceeds of the seller will be taxed as investment income. The taxable basis (in proportion to the percentage of the shares sold) corresponds to the smallest amount of the following elements:

- share sale proceeds including amounts paid under conditions;
- amount of substance distribution;
- amount of retained earnings available for distribution under company law as of the last balance sheet date preceding the share sale; and
- amount of non-operating assets as of the share sale date.

3.4. Tax assessment

The taxable amounts are deemed to be realized in the tax year during which the relevant share sale has occurred. This can mean that the taxable amount must be allocated to different tax years in the event of staggered share sales. If the taxpayer already has been finally assessed for the relevant tax year, the assessment will be reopened in order to assess the additional income tax.

3.5. Tax rulings

3.5.1. Competence

The new Circular clarifies that tax rulings concerning indirect partial liquidation issues may be issued only by the tax authority that is competent for the tax assessment of the selling shareholder.

3.5.2. Scope of binding tax rulings

Any tax ruling prior to an envisaged share sale may refer only to the date of the sale and cover the following points:

- certain objective criteria: sale of shares, "change of system", five-year period, distributable reserves;
- qualified participations (at least 20% of the share capital), eventually in view of further sales planned to occur within the next five years; and
- facts which must be tested under the concept of "distribution" and which are planned to be implemented simultaneously with, or shortly after, the share sale.

An indirect partial liquidation may be excluded only at such point in time, if either one of the required objective criteria is not met, or if the target company has no non-operating assets. The tax authority, when being asked whether a particular fact pattern amounts to a distribution will answer such question and, in the affirmative, will determine the amount of non-operating substance including valuation of assets, and it will issue an opinion on the cooperation issue.

23. Federal Tribunal, 9 July 1996, *X gegen Bundessteuer-Rekurskommission, Archiv für Schweizerisches Abgaberecht* 66 (1997/98), at 146 et seq., Para. 5c(bb).

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