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Recent Developments on International Taxation
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by

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I. RECENT LEGISLATIVE DEVELOPMENTS OF INTEREST

A. Swiss Domestic Tax Legislation

1. At Federal Level

Swiss tax legislation is currently undergoing a fundamental review and many reforms have been undertaken recently or will be undertaken in the near future.

1.1 Reform of the Taxation of Enterprises II ("RTE II")

Under this draft legislation, the Federal Council has proposed several measures to the Parliament that are generally regarded as enhancing the fiscal attractiveness of Switzerland.

None of these amendments was in force or, indeed, even finalized by the date on which this report was written, except two topics that are likely to enter into force on 1 January 2007: the limitation of the "Indirect Partial Liquidation" theory (see 1.1.1, below) and of the "Transposition" theory (see 1.1.2, below).

1.1.1 Limitation of the "Indirect Partial Liquidation" Theory

The so-called "indirect partial liquidation" was introduced in the 1980s. It typically applies when an individual sells shares of a target company – forming part of his private assets – to a purchaser which is a company. Initially, since capital gains are tax-free in Switzerland, whereas the distribution of dividends from a company to an individual shareholder is taxed, it was considered, under the tax evasion theory, that the accumulated profits not reinvested in the business should be distributed to the seller in the form of dividends prior to the sale of shares,

rather than being accumulated in the target company and “distributed” indirectly and tax-free through the payment of the purchase price (i.e., capital gain by the seller).

Since then, application of this theory has been steadily extended by the Federal Supreme Court, which has given rise to increasing legal uncertainty. The latest change dates from 11 June 2004 (see IBA Report on Switzerland, 2005).

This case evoked strong reaction among tax practitioners and scholars because of its negative impact on the Swiss M&A business and its implications for passing over businesses to future generations, and made it evident that a clear legislative concept was needed.

According to the new law, the proceeds from a sale (i) by an individual to a company (ii) of a participation of at least 20% shall be taxed as an indirect partial liquidation if, (iii) within a period of five years following the sale, (iv) funds which existed at the time of the sale and which were not necessary to run the target’s business are distributed from the target to the purchaser, and (v) the seller and the purchaser cooperate in distributing these funds.

The new law will represent a substantial improvement over current practice and is expected to enter into force on 1 January 2007. The cantons will have one year more to implement the new law into their legislation.

1.1.2 Limitation of the "Transposition" Theory

Connected with the issue described above, the “transposition” theory addresses the case of a “sale to oneself”, i.e., the sale of the shares by the seller to another company which he himself controls, converting potentially accumulated profits of the target company into tax-free par value (shares) and/or debt. Note that the Swiss tax system applies the “par-value principle”, i.e., all distributions made by the company to its shareholder, in capital or in kind, represent taxable income for the shareholder, to the extent that they exceed the par value of the shares.

The new law, which is expected to enter into force on 1 January 2007, restricts application of the “transposition” theory to cases where the seller owns at least 50% of the acquiring

company. In addition, the new law excludes the application of a transposition when the shareholding sold represents less than 5% of the target company.

1.1.3 Other RTE II Issues

Many other important tax law issues are addressed under the RTE II project and are currently under review. Unfortunately, the legislative process has been delayed somewhat and it is unlikely that these bills (except those mentioned above, 1.1.1 and 1.1.2) will enter into force on 1 January 2007.

The topics currently under review include (i) the important limitation imposed on the tax authorities to characterize (tax-free) private capital gains as (taxable) professional securities trading gains for individuals- in contrast to the current practice of the Federal Supreme Court, (ii) the reduction of economic double taxation for individuals (partial taxation of dividends, varying between 50 and 80%), and (iii) the introduction of the “capital contribution principle” in place of the currently applicable “par value principle” (for a definition of the latter, see 1.1.2, above), which means that the paid in capital in excess of the par value (= agio) will also be tax exempt when repaid to the shareholder .

1.2 Reform of the Taxation of Pension-Fund Financing

Switzerland has a pension-fund system based on the principle of capitalization. Ordinary premiums have to be paid by both the employees and employers. It can happen that an employee does not have the full amount of coverage (“gap in coverage”) due to missing premiums as the result of admission to a new pension plan or a salary increase, for example. The employee may want to reduce this gap in order to obtain the full benefit of advantages provided by the pension plan. To do so, he can pay additional pension premiums (the so-called repurchase of pension entitlements). In principle, pension premiums may be fully deducted from the taxable income when paid by the employee into the pension fund and are taxable when paid out after retirement by the pension fund to the employee. The advantage is an important tax deferral as well as a normally lower marginal tax rate at the age of retirement. If the retired employee asks for a lump-sum capital payment of his savings capital instead of an annuity, the tax rate is reduced substantially (discount of up to 80% of the ordinary tax rate).

On January 1, 2006, some amendments to the Federal Act on Occupational Benefits (“FAOB”) came into force, to some extent restricting the planning options that were previously available.

For example, the insured salary has been limited to CHF 774,000, which corresponds to a maximum FAOB savings amount of CHF 9,300,000.00 at 65 years of age. Moreover, guidelines have been set for the repurchase of pension entitlements, particularly for foreign expatriates moving to Switzerland (a maximum of 20% of the insured salary may be deducted during the 5 years after taking up residency in Switzerland).

On the other hand, some new options have been introduced, among them that of providing for up to three pension plans within the same pension fund.

1.3 New Federal Act on Collective Investments

A complete overhaul of the Federal Act on Investment Funds has been passed and the new law, labelled Federal Act on Collective Investments (“FACI”), is expected to enter into force on 1 January 2007.

The main purpose of this new law was to bring the regulatory and civil aspects of Swiss legislation into line with European standards. Specifically, alongside the existing “common contractual investment fund”, the law created new categories of investment vehicles under Swiss law, including “SICAV” (open-end investment companies), “SICAF” (closed-end investment companies) and “investment limited partnerships”.

The law does not provide for any major changes or improvements in taxation over the current legislation on investment funds.

For the contractual investment funds, SICAV and investment limited partnerships¹, the basic principle is the one of “partial fiscal transparency”, enforcing – to a certain extent- the “same business, same rules” principle. In a nutshell, these three FACI vehicles will not be subject to income or profit tax, but to the Swiss 35% withholding tax on their income, whether distributed

¹ The tax treatment of the investment-limited partnership is covered in detail in Chapter V.B.1.

or retained. As an exception, no withholding tax will be levied on (i) capital gains accounted separately by the FACI vehicle and paid out to the investor by separate coupon or (ii) income from FACI vehicles with predominantly (i.e. more than 80%) foreign source income, via an affidavit. The income/gain of the FACI vehicle is characterized (capital gain or income) following the individual investor's income tax rules. When the income is subject to the 35% Swiss withholding tax, the Swiss investor is entitled to a full refund at the time of submitting his income tax return. A foreign investor can obtain a full refund of the withholding tax based on Swiss internal law, if 80% of the income of the FACI vehicle is of foreign source. If this condition is not fulfilled, the foreign investor can obtain a refund only to the extent and on the basis of a double taxation agreement.

The partial transparency approach described above will not apply to SICAFs (which will, as a rule, be taxed as joint-stock companies, i.e. subject to double economic taxation) and FACI vehicles that directly own real estate (which will, as a general rule, be subject to taxation at the level of the vehicle and exempted at the level of the investor).

Finally, it is worthy of mention that, in contrast to the current taxation system, the 35% withholding tax payable on capitalisation funds ("fonds de thésaurisation") will be collected on an annual basis, bringing it into line with the current system applicable to direct income tax. This change may however lead to some practical problems for the fund administration, imposing a possibly burdensome differentiation of Swiss investors and foreign affidavit-investors.

1.4 New Legislation governing Foundations of Public Interest

The civil legislation governing foundations was revised on 1 January 2006. At the same time, some tax provisions were amended.

With respect to direct tax, contributions to public-welfare or charitable foundations are deductible from income at federal level, up to a limit of 20% of net income (instead of the 10% previously applicable).

The VAT law was also amended to provide VAT exemptions for sponsoring entities which pursue public welfare or charitable objectives, provided that the beneficiary of the sponsorship pays no consideration in return.

1.5 Taxation of Married Couples

With respect to federal income tax, dual-income married couples are currently discriminated against cohabiting couples in the same situation. Indeed, because the two incomes are added together, the progressive increase in taxation is not offset by a corresponding deduction. This year, the Federal Council submitted to Parliament a draft amendment designed to reduce this disparity. New tax deductions intended to reduce the progressive effect associated with combining incomes for tax purposes are scheduled to come into force for the fiscal year beginning 1 January 2008.

1.6 Value Added Tax ("VAT") reform

The expert appointed by the Federal Council to examine the issue of VAT reform submitted his report to the government in May 2006. This report stresses the urgent need for a complete overhaul and simplification of the VAT Act. A draft law should be available by the winter of 2006-2007.

1.7 Update on Taxation of Employee Stock Purchase Plans ("ESPP") and Employee Stock Option Plans ("ESOP")

The deliberations on the law amending taxation rules for stock options (see the detailed description in the IBA Report on Switzerland, 2005) have been delayed, as one of the houses of Parliament has requested a study from the Federal Council on the financial effects of this law. As a result, this new law will certainly not come into force on 1 January 2007, as previously expected.

In a nutshell, according to this draft law, employee shares (ESPP) will be taxed on the date they are granted (in line with current practice at federal level) while employee options (ESOP) will, in principle, be taxed on the date they are exercised (as opposed to the present taxation in

general at the time of granting). The taxable amount will be equal to the difference between the purchase price (or exercise price) and the fair market value of the underlying shares. In both cases (ESPP and ESOP), the tax authorities take into account a rebate which is based on the blocking period on the financial instrument. Furthermore, the new law basically incorporates the OECD's recommendations on ESOP taxation in cross-border situations.

2. At Cantonal Level

2.1 Regressive Income Tax

At cantonal level, tax competition between the cantons, specifically in respect of tax rates, has been at the centre of much debate. For individuals, certain cantons have introduced regressive income tax scales (in other words, the marginal tax rate is reduced for the highest income levels) while certain cantons have even adopted regressive tax scales for corporation profit tax. Citizens have filed an objection against some of these new laws with the Federal Supreme Court, which will have to decide whether they are in line with the Constitution. In any event, the trend is clearly moving towards lower cantonal tax rates.

2.2 Taxation of Trusts

In autumn 2006 Switzerland is expected to ratify the Hague Convention on the recognition of trusts.

Uniform tax guidelines aimed at standardising often divergent tax policies in the cantons, are currently being drafted by the tax authorities.

The main issues under dispute are (i) the recognition of the transfer of assets to the trust (particularly when the settlor is a Swiss resident) and (ii) the fiscal qualification of distributions from discretionary trusts to Swiss beneficiaries.

On the second point, distributions are generally treated as taxable income for a Swiss resident. Certain cantons differ on this question, recognizing in some cases the qualification of capital gains realised by the trust – if the trust accounting rules allow them to be identified - which,

under certain conditions, may be distributed tax-free to the beneficiary. There are also differences in terms of the possibility, under certain conditions, of qualifying the trust distribution to the beneficiary as a (tax-free) donation, for the amount of the distribution corresponding to the capital initially contributed into the trust.

B. International Developments

1. Double Taxation Treaties

1.1 New Swiss Double Taxation Treaties

Over the past year, new treaties for the avoidance of double taxation on income and capital gains have been signed (there is still some uncertainty surrounding their date of entry into force) with:

- Azerbaijan (on 23 February 2006) and
- Algeria (on 3 June 2006).

Furthermore, a new tax treaty with Serbia-Montenegro came into force on 5 May 2006, and will become effective from 1 January 2007.

1.2 Treaty Amendments and Memoranda of Understanding

1.2.1 In General

For the record, Switzerland signed the “Bilateral Agreements II” package with the European Union (“EU”) in 2004 (for details, see the IBA Report on Switzerland, 2005). These included the “Agreement on taxation of savings”, which introduced (i) a withholding tax on interest paid by a Swiss paying agent to an individual EU-resident; (ii) Swiss access to the EU Parent/Subsidiary Directive (i.e., full relief from source taxes on cross-border dividends), as well as to the EU Directive on intra-group payments of interest and royalties; and, finally (iii) a more extensive exchange of information with the EU.

On the latter point, Switzerland has signed a Memorandum of Understanding agreeing to re-negotiate the exchange-of-information clauses (cf. Art. 26 of the OECD's Model Convention) of all its existing double taxation treaties with EU countries, to provide for a more extensive exchange of information, i.e., also permitting an exchange of information for the administration and enforcement of domestic tax laws of the contracting state, but only in the event of tax fraud or the like. It is important however to note that Switzerland requires the principle of double incrimination (or dual criminality) for this provision to be applied.

Furthermore, in exchange for removing Switzerland from the "black list" of countries engaging in harmful tax competition, the OECD also obtained Switzerland's agreement to extend the exchange of information with respect to Swiss resident holding companies even further, since the prerequisite of tax fraud or the like is not necessary for the exchange of information on this kind of company.

These two important amendments relating to the exchange of information will gradually be integrated into all double-taxation treaties with EU countries.

1.2.2 In Particular

Among the treaty amendments and protocols which have been finalized during recent months, the following should be noted:

- The amended Swiss-Norwegian Treaty came into force on 20 December 2005. The most important amendments concern (i) a change in the method used by Norway for avoiding double taxation (moving from the exemption method to the tax credit method), (ii) full exemption from withholding tax on dividends to companies with qualified shareholdings and (iii) the aforementioned (see I.B.1.2.1) extension to the exchange of information in the event of tax fraud and with respect to holding companies.
- In relation to the Swiss-Austrian treaty, a protocol was signed on 21 March 2006. The most important changes are (i) the taxation of commuters at their place of employment (currently in the state of residence, with a 3% tax at source in the state of employment); (ii) full exemption from withholding tax for license fees; (iii) a deferral of taxes on

unrealized capital gains upon leaving Austria; and (iv) the aforementioned (see I.B.1.2.1) extension to the exchange of information in the event of tax fraud and with respect to holding companies. A new Swiss Ordinance also came into force on 1 July 2005, which stipulates that under certain conditions an Austrian debtor may be able to obtain relief at source on withholding tax.

- With respect to the Swiss-Finnish treaty, a protocol was signed on 19 April 2006 which provides for (i) full exemption from withholding tax on dividends to companies with qualified shareholdings and (ii) the aforementioned (see I.B.1.2.1) extension to the exchange of information in the event of tax fraud and with respect to holding companies.
- As for the Swiss-UK treaty, some amendments were agreed upon in a protocol signed on 18 January 2006. The most important changes concern (i) full exemption from withholding tax on dividends to companies with qualified shareholdings and pension funds; (ii) new rules on the taxation of pension assets and deductions for social security and pension-fund contributions (cash payments of pension-fund capital will be taxable exclusively in the state of source; a contribution paid in one country will be deductible in the other country under certain conditions only); and (iii) the aforementioned (see I.B.1.2.1) extension to the exchange of information in the event of tax fraud and with respect to holding companies. At the same time, the two countries signed a memorandum of understanding providing for a simplified procedure for refunding withholding taxes to collective investment vehicles. Interestingly, claims which were submitted to the tax authorities on or after 1 January 2000 and subsequently refused may be resubmitted for review under the new procedure.
- With respect to the Swiss-Spanish treaty, a protocol was signed on 29 June 2006 which provides for (i) a full exemption from withholding tax on dividends to companies with qualified shareholdings and a general exemption from withholding tax on interests (ii) the aforementioned (see I.B.1.2.1) extension to the exchange of information in the event of tax fraud and with respect to holding companies. It is important to note that this protocol was much awaited, since Spain had made it a prerequisite for granting the

benefits of Article 15 of the Bilateral Agreement on the taxation of savings (which provides for the full relief of withholding taxes on cross-border dividends, pursuant to the so-called “Access to the EU Parent/Subsidiary Directive”; see I.B. 1.2.1, above)

2. Swiss-EU Bilateral Agreements II and Related Issues

The Swiss tax authorities have officially declared that the Swiss Anti-Abuse Protocol of 1962 (with all of the related instructions) applicable with regard to double-taxation treaties, also applies to Article 15 of the Bilateral Agreement on the taxation of savings (which provides for the full relief of withholding taxes on cross-border dividends, pursuant to the so-called “Access to the EU Parent/Subsidiary Directive”; see I.B. 1.2.1, above).

II. RECENT COURT DECISIONS OF INTEREST

A. Broadening the scope of taxation of foreign offshore companies managed and controlled in Switzerland (Tax Consolidation)

On 30 January 2006, the Federal Supreme Court (the “Supreme Court”) issued a judgement (2P.92/2005) in which the profits of a Panamanian offshore company were fully consolidated into a Swiss (sister) company, on the basis of the tax avoidance theory (i.e. abuse of law).

The Supreme Court notes that, under certain conditions where relevant and objective grounds exist, the tax authorities may retain an economic approach and qualify a legal entity as transparent, attributing its income to the beneficial owner. Moreover, the Supreme Court adds that “the utmost caution” must be exercised, from a tax point of view, when dealing with companies located in countries where the laws encourage the incorporation of companies for tax purposes, as is the case in Liechtenstein and Panama.

In this particular case, the Supreme Court ruled that the offshore company “was not in any way independent”, basing itself in particular on the following factual elements: the offshore company was effectively managed from the Swiss company’s offices in Geneva; the documents specific to each of the companies were not separated; the staff was employed by the

Swiss company and worked for both of the companies; both companies had a bank account with the same bank involving mutual collateral pledges; invoices were issued by the Swiss company but payments were credited to the offshore company's bank account, etc.

In these conditions, the Supreme Court decided that the offshore company was not a separate (distinct) entity and that it was unusual for this company to be incorporated in Panama. Furthermore, the location enabled the company to achieve substantial tax savings. The Supreme Court concluded that this case satisfied the conditions of a tax avoidance scheme (abuse of law) and that the tax authorities could therefore ignore the legal entity of the company and allocate the offshore company's taxable income directly to the Swiss company.

The Supreme Court broke new ground in this judgement by introducing a new weapon Swiss tax authorities can use against offshore companies: consolidation for tax purposes on the sole basis of a tax avoidance scheme. This method is easier for the tax authorities to apply compared to the classical effective management test, as they are no longer required to register a new taxpayer in Switzerland and can immediately take steps to collect from the Swiss taxpayer which already exists. Moreover, the consolidation theory means that the tax authorities do not have to challenge, if applicable, the transfer prices between the Swiss company and the offshore company.

This judgment constitutes a new means of repatriating to Switzerland the profits of an offshore company, following those of (i) the effective management office in Switzerland (see the IBA Report 2005 on Switzerland), (ii) the permanent establishment, (iii) the transfer prices and (iv) the agency theory ("Suchard Case").

It can only be hoped that the Supreme Court's recent decision will remain an isolated case, driven by the facts and extreme circumstances of this particular case, and that the great legal uncertainty that it could create will not adversely affect our country's attractiveness as a place for foreign corporations to invest.

B. An offshore company does not in itself constitute tax evasion

Within the actual context, a judgement by the Supreme Court dated 1 March 2006 (1A.316/2005) represents a contrast to the aforementioned case and is worthy of mention here. In this decision, the Supreme Court ruled that an offshore company does not, in itself, constitute a case of tax fraud.

In this case, the German criminal authorities had approached the Swiss authorities with a request for mutual legal assistance, for the purpose of obtaining all the relevant documents concerning the Swiss bank account of an offshore company (Cyprus).

The defendants were charged in Germany with having transferred a portion of their profits to an offshore company with the intention of avoiding tax in Germany. However, the Swiss Supreme Court was not able to find any evidence that the taxpayer intended to maliciously mislead the tax authorities. Indeed, there were no allegations whatsoever that the defendants had attempted to deceive the German tax authorities by making fraudulent statements or, in particular, by filing forged or falsified documents. In the absence of any evidence of tax fraud, the request for mutual legal assistance was rejected by the Supreme Court.

III. RECENT TRANSACTIONS OF INTEREST**A. Bilateral Agreements II**

The Bilateral agreements II and, in particular, access to the EU Parent/Subsidiary Directive (see above I. B. 1.2.1), are fully effective and this is currently encouraging many international groups of companies to establish their international headquarters in Switzerland.

These agreements with the EU are an ideal complement to the generally attractive tax situation in Switzerland. These can be summarised as follows: a company may obtain privileged tax status in Switzerland, either through the holding or the auxiliary status (the latter when income is mainly from foreign source). This allows to reduce the overall ordinary tax rate from approximately 24% to 8%-12%, depending on the Swiss canton/commune in which the

company is registered. Furthermore, attractive conditions are available for managers, through tax planning with ESPP/ESOPs (see I.A.1.2, above) and pension-fund contributions (see I.A.1.2 above). Finally, work permit conditions have been gradually eased for employees coming from EU and EFTA (European Free Trade Association) countries, since the entry into force of the Swiss-EU Bilateral Agreement on the Free Movement of Persons in 2002. It is worth mentioning that from April 1st 2006, the latter Agreement has been extended to citizens of the new EU members (Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia and the Czech Republic). The benefit of this agreement for citizens of these new countries will however be phased in, between 2006 and 2014 (except Malta and Cyprus, which will be treated immediately like the previous “old” EU countries).

B. The Bonny Decree

Under this decree, an existing or newly incorporated company may qualify for a partial or full tax holiday at federal level, in addition to a tax holiday at communal/cantonal level, for a maximum period of 10 years.

To obtain the tax holiday, the main factor will be whether the investment is of sufficient economic importance to a particular canton. For example, the number of jobs created or the economic development of specific regions will be considered. Most cantons in Switzerland have regions that qualify for the Bonny Decree but the cantons of Geneva, Zurich and Zug are among nine cantons that do not qualify for the Bonny Decree exemption.

The Bonny Decree, initially due to end in June 2006, was extended this year through the end of 2008. The Bonny Decree extension is expected to have a positive impact on foreign investors' decisions on whether to invest in Switzerland. It is already expected that a new law will replace the Bonny Decree after 2008.

IV. SINGLE MOST SIGNIFICANT TAX DEVELOPMENT

In our view, the new regulation on indirect partial liquidations (see I.A. 1.1.1, above) was the highlight of the year for the Swiss tax system. This regulation substantially reduces the obstacle

that has stood in the way of numerous transactions (LBOs and MBOs) involving Swiss target companies held by Swiss residents.

V. SPECIAL TOPIC: PRIVATE EQUITY INVESTMENT, TAX ISSUES IN SWITZERLAND

By private equity, we commonly understand the financing of non-listed companies in start-up (venture capital), growth (capital development) and shareholder transfer (buy out) stages. For some years now, private equity has also been offering investors a new category of alternative assets for wealth management.

The tax issues of a private equity investment from the point of view of the various parties involved are analysed below.

Section A concerns the parties directly involved in a private equity transaction, which are (1) the target, (2) the seller and (3) the buyer. Section B deals with the parties investing in this type of transaction, which are (1) the investment vehicle and (2) the investors. Finally, a short section C will touch on the issue surrounding the people responsible for the management of either the target company or the investment vehicle.

A. The private equity transaction: purchase, holding then resale of a non-listed company

In practice, the purchase of a target company located in Switzerland generally takes the form of a *share deal*, i.e. the acquisition of the shares of the target company. The main reason for this is that, from a tax point of view, it is in the interest of the seller – whether an individual or legal entity- to sell the shares in the target company rather than to sell the assets separately². Furthermore, the buyer's investment in the target is generally made by a legal entity, either (i) through an ad hoc acquiring holding company (special purpose vehicle or "SPV") or (ii) through direct investment from the legal entity making the purchase (a holding company controlling a group of companies, for instance). The main reason for a purchase through a legal

² This article does not deal with legal or administrative criterions which must also be taken into account in any transaction (the issues relating to guarantees, transfer of property, etc.) which may favour the adoption of one or other of the solutions (share deal or asset deal) depending on the party involved (buyer or seller).

entity is to ensure both the optimal management of the acquisition debt and to ensure that the capital gain resulting from the sale of the shares remains exempt from tax.

We will therefore focus on share deals³ realised by an acquiring holding company, referred in this article as the “SPV”.

1. The Target

By hypothesis, the target company is a Swiss legal entity, taking for example the form of a joint stock company (“SA”) or a limited liability company (“Sàrl”).

At this level, the issue of losses carried forward by the target company must be taken into account.

In the case of a share deal⁴, the losses carried forward by the target pass onto the buyer together with the target company’s assets and liabilities, because the taxpayer (the SA) is being sold in its entirety, with its legal status and all the tax attributes linked to it. The buyer will therefore be able to keep the losses carried forward by the target company and offset these against future profit made by the target company, or with much more difficulty, by the buyer (following a post-acquisition merger, unless viewed as an abuse of tax law, see V.A.3.1.2 below).

2. The Seller of the Target

2.1 Where the seller is an individual

In the case of a share deal⁵, an individual can realize a tax-free capital gain, if the indirect partial liquidation issue does not apply (see above I.A.1.1.1) and if the shares are not held as

³ For information, a footnote reference will be made to the prevailing solution in the hypothesis of an “asset deal”.

⁴ In the case of an asset deal: the losses carried forward are not passed onto the buyer, they remain with the seller (tax attribute inherent to the taxpayer which is not sold).

⁵ In the case of an asset deal (i.e. the sale of the assets of the target company in which an individual is a shareholder), the difference between the fair market value of the assets, including goodwill (in other words the selling price) and the book value of the assets is taxable at the level of the target company. Furthermore, the distribution of the liquidation proceeds of the target company to its individual shareholder is subject to income tax, irrespective of whether their investment falls into the category of private asset or commercial

business assets (for example, if Swiss tax authorities characterize the seller as “professional securities trader”).

2.2 Where the seller is a legal entity

In the case of a share deal⁶, the sale of shares triggers also a tax free capital gain, if the conditions for the participation exemption are met (these being, in short, a minimum participation of 20% held for a minimum of one year). There is no tax impact on the target company.

In addition, for both the individual and the legal entity, a share deal allows a tax saving by eliminating the transfer tax on the real estate (or certain securities) held by the company.

3. The Buyer of the Target

3.1 Acquisition and Holding of the Target by the Buyer

As mentioned above (section V.A), for a Swiss target company, the buyer will generally use an SPV, normally a Swiss SA⁷ with holding company status. Therefore, for the purpose of this article, the SPV will be considered to be the buyer.

3.1.1 *General rule: non-consolidated taxation approach*

assets. This distribution is also subject to withholding tax at the rate of 35%, which is refundable only to Swiss residents (which are subject to Swiss income tax) or under a double taxation agreement.

⁶ In the case of an asset deal (i.e. the sale of the assets of the target company in which the shareholder is a legal entity) the difference between the fair market value of the assets, including goodwill (in other words the selling price) and the book value of the assets is taxable at the level of the target company (similarly to the previous hypothesis, see footnote 5). However, the distribution of the liquidation proceeds of the target company to the shareholding company (the SPV) is basically tax exempt, if the conditions for the participation exemption are met. Furthermore, the distribution is subject to the 35% withholding tax, which may be refunded (or settled directly through the declaration procedure) by a Swiss resident company. Non Swiss-resident companies can obtain a refund (or benefit from the declaration procedure) only to the extent and on the basis of a double taxation agreement or the Agreement on taxation of savings which Switzerland has signed with the EU (so-called “access to the Parent/Subsidiary Directive”, see above I.B.1.2.1).

⁷ If the purpose of the Swiss joint stock company (SA) is to provide venture capital to Swiss companies and it invests at least 50% of its equity in start-ups, it is exempt from Swiss stamp duty and qualifies for a more generous participation exemption (5% participation required instead of the normal 20%, or CHF 250,000.00 required instead of the normal CHF 2 million). This article does not cover the concept of business angels, which is provided for by law but very rarely used in practice.

Generally, buyers have a consolidated financial approach to their transactions. However, Swiss tax law does not allow group taxation for net income tax, so tax consolidation (income/deductions) of the SPV and the target company is not possible. Both entities must remain separate from a tax point of view.

This being said, from the point of view of the buyer (the SPV), there are three important aspects to be taken into account:

- 1) The first is the issue of amortization of the target's goodwill and hidden reserves (included in the purchase price which exceeds the net asset value of the target company).

In the case of a share deal⁸, the possibilities of tax deductible amortization are limited:

- (i) In principle the tax authorities do not permit direct amortization *through the SPV* of the target's goodwill and hidden reserves because the shares purchased are capitalised in the books of the buyer as an "investment" in a participation, which is not depreciable in the same way as an ordinary tangible or intangible commercial asset (goodwill for instance). Tax deductible depreciation of an investment is only permitted if it is economically justified, i.e. if the fair market value of the shareholding has effectively fallen. Note that, even in cases where depreciation of the investment is accepted by the tax authorities, no substantial tax benefits are generally gained, if the SPV is a pure holding company and the conditions for the participation exemption are met (a shareholding of at least 20% or CHF 2 million), since it offsets against income which is not taxed or taxed at a low rate.

⁸ An asset deal, on the other hand, provides more possibilities for amortization because the objects acquired are assets (tangible or intangible such as goodwill) and not a shareholding. In this case, the effective price paid for the assets is allocated to the different assets, and the remaining goodwill is capitalised in the books as "goodwill". Depreciation is permitted over a given period (goodwill over 5 years, for example) and is 100% deductible from the taxable operating profit. This makes the asset deal more advantageous for the buyer.

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- (ii) As regards the indirect amortization of goodwill and hidden reserves *through the target company*, it is not possible to apply a tax-neutral “step up in basis” of the assets at the level of the target company, followed by their amortization.
- 2) The issue of financing costs is also an important element of private equity transactions (especially in cases of LBO), due to the generally high level of debt financing:
- a) *As regards repayment of the debt*, in the case of a share deal⁹ made by an SPV, the SPV can allocate a maximum portion of the profits generated by the target company to the repayment of debt. In fact, these profits are taxed through the target company only, at a corporation tax rate of approximately 24%, and distributed basically tax exempt to the SPV (if it is a holding company and the aforementioned conditions for the participation exemption are met). In comparison, this distribution by the target would be subject to an additional 45% income tax in case of direct acquisition by an individual.
- b) *When it comes to the payment of interest expenses*, in the case of a share deal¹⁰ made by an SPV, deduction of interest expenses from the debt at SPV level does not generally present any tax benefit because it offsets profits which are in principle not taxed or taxed at a low rate (if the SPV is a holding company and the aforementioned conditions for the participation exemption are met). Thus the interest expenses cannot be deducted from operating profits, which are taxed separately at the level of the target company (except the scenario of a post-acquisition merger, see V.A.3.1.2 below).
- 3) Finally, in the case of a share deal¹¹, a third factor must be taken into account from the point of view of the buyer and concerns the withholding tax. A 35% withholding tax is due on any distribution by the Swiss target company and is, as a rule, fully reimbursable

⁹ In an asset deal, the same result is achieved since the target’s operating profit is generated within the entity with which the debt lies. The after-tax profit can therefore be used to repay the loan directly. Therefore, in this respect, from a tax point of view, there is no difference between the share deal and the asset deal.

¹⁰ In an asset deal, however, interest expenses are directly 100% deductible from the taxable operating profits generated by the assets purchased, which are held within the same entity as the debt. This makes the asset deal more advantageous for the buyer.

¹¹ This issue does not arise in an asset deal.

for a Swiss SPV. An issue may arise in connection with the “old reserves theory” in the case of the purchase of shares (by the Swiss SPV) from a foreign resident who does not benefit from a complete refund of the withholding tax on the basis of a double taxation agreement. In this case, the withholding tax retained on the distribution of the old reserves existing at the time of the purchase may be refunded to the Swiss buyer to the same conditions/rates that would have been applicable to the foreign seller. These old reserves are the liquid assets unnecessary for business purposes, which correspond to accumulated profits. The latter have not been distributed in order to avoid withholding tax, the foreign shareholder preferring to realise a capital gain (which is exempt from withholding tax).

3.1.2 Exception: Tax consolidation through post-acquisition merger

As already mentioned, given that Swiss law does not recognise group taxation, the taxpayer cannot opt for tax consolidation of the SPV with the target company purchased. An equivalent result can however be achieved technically through a post-acquisition merger of the parent company and the (acquired) subsidiary. In this respect:

- 1) The “merger loss” is the difference between the purchase price of the shares (capitalised in the books of the purchasing parent company) and the net asset value of the subsidiary acquired. It corresponds to the goodwill and hidden reserves on the assets of the target company. Fiscally, a distinction must be made between:
 - A “merger loss” is not deductible if it is an “improper merger loss”, which is generally the case. In this case, the loss only exists in the accounts and does not constitute an actual economic loss or depreciation, but corresponds simply to the goodwill and hidden reserves on the assets of the target company.
 - On the other hand, the deduction is fiscally accepted in the case of a “proper merger loss”. Here the accounting loss equates to an actual loss in value of the participation in the target company. To obtain the tax deduction of a “proper merger loss”, the buyer has to prove that the book loss does indeed equate to an actual economic loss

of the value of the target (this is a similar issue as the one relating to direct depreciation of an investment, see point V.A 3.1.1., 1 (i) above).

- 2) The merger of the purchasing company with the target company has two other tax consequences: (i) a debt push down, meaning that the interest expenses can be deducted from operating profits (see above V.A.3.1.1, 2 b) and (ii) the losses carried forward by the target company are transferred to the buyer (see V.A.1). However, Swiss tax authorities generally view the post-acquisition merger as a tax avoidance scheme (abuse of tax), if the merger has been carried out purely for tax savings purposes. In other words, there must be very good commercial reasons in support of the merger. In practice, if the merger takes place within five years of the purchase and within the SPV, it will be qualified as abuse.

3.2 Subsequent Sale of the Target by the Buyer

As stated above, the sale by the SPV of its shares¹² in the target company equates to a tax-exempt capital gain if the conditions for the participation exemption are met (20% participation for one year).

However, if the purchase of the shares in the target company has been realised through an SPV and the SPV has sold its shares in the target company, a withholding tax issue may arise on liquidation of the SPV, when the capital gain is distributed to the shareholder. In fact, if the SPV is a Swiss holding company, a 35% withholding tax is levied on all dividends, including the liquidation dividend. The withholding tax is refundable only to Swiss residents shareholders or under the benefit of a double taxation agreement. One possible solution to avoid this is simply to sell the shares of the SPV instead of the shares of the target. In addition, one can consider to put in place, above the Swiss SPV, a foreign intermediary SPV whose jurisdiction (i) has a 0% rate on the basis of a double taxation agreement or art 15 of the Bilateral Agreement with the EU on the Taxation of Savings (so-called “access to the Parent/Subsidiary EU Directive, see above I.B.1.2.1) and (ii) does not levy a withholding tax on the liquidation dividend.

¹² For the hypothesis of an asset deal, see footnote 6 above

B. The Investors

In this section we will look at the tax consequences for the investor and the investment vehicles they use.

1. The investment vehicle

The private equity investment vehicle may be Swiss or foreign¹³.

It is worthy of mention that there is practically no check-the-box rules in Swiss tax law. The transparency/non-transparency of all Swiss entities is determined by Swiss tax legislation whilst the transparency/non-transparency of foreign entities depends, in principle, on its legal status (legal personality). Even though, in practice, it is sometimes possible to obtain the recognition of the foreign tax transparency status of foreign entities, independently from their legal form.

Under current Swiss law, there are two possible categories of Swiss investment vehicle:

a) The “investment companies” category: investment companies or investment partnership

- (i) Investment companies are legal entities (for example an SA) who are taxed at level of the company. The profits are subject to economic double taxation. The capital gain realised by the company is subject to corporation profit tax (unless the conditions for the participation exemption are met, see V.A.2.2 above). If the profits are distributed to the investor, a 35% withholding tax is payable by the company on the dividends and the investor pays income tax. The withholding tax is refundable to Swiss residents or by virtue of a double taxation agreement for a foreign investor. On the other hand, retained profits by the company are not subject to either withholding tax or income tax. The capital

¹³ This article deals with the tax aspects only. Other important issues (such as the fees or the negotiability of the shares) will not be addressed.

Neither will we address the issue of “funds of funds”. From a tax point of view, as long as all the vehicles (funds) are fiscally transparent, the same principles may apply.

gains realised by the investor by the sell of his shares held in his private assets is tax exempt.

- (ii) Swiss partnerships (for instance a limited partnership) are taxed in transparency, i.e. only once, in the hand of the investor, upon income generation and not distribution. The company is subject to neither profit tax nor withholding tax.

b) Investment funds category

Swiss *investment funds* are taxed in (partial) transparency (see above I.A.1.3). In general, the investment is not considered to belong to the commercial assets of the investor -because the latter has no management rights- but to his private assets, on which capital gain is tax exempt.

It is current practice for the vast majority of private equity investments to be made via limited liability partnerships. For the purpose of private equity investments, these vehicles must ideally be “close end”, pass-through (tax transparency) and permit the capital gain made by the vehicle to be recognised as an investor’s capital gain in his private assets.

As it currently stands, Swiss law offers no vehicles which meet these criteria. Currently (in principle until 31 December 2006) the Investment Funds Act provides only for “open end” funds which are generally not suitable for private equity investments. As far as Swiss partnerships are concerned, despite the fact these are “close end” and are fiscally transparent, they fall in general into the commercial assets category, which means that the investor has to pay income tax on the capital gain. The only variant sometimes actually used is a Swiss joint-stock company (for instance an SA) which retains the capital gains without distributing them. The investor can realise a (tax-exempt) capital gain by reselling his shareholding to a third party. To facilitate the resale of the shareholding, the company may be listed on the stock exchange. In addition to the fact this is a burdensome procedure, there is also the inconvenience of a discount in value resulting from the latent withholding tax on the capital gains retained by the company.

For these reasons, the investment vehicle generally used in Switzerland is a foreign limited partnership which may be in practice taxed in Switzerland as an investment fund, at least if the investor has no management rights (like in an investment fund).

From 1 January 2007, a new *Swiss investment limited partnership* (the “Swiss investment LP”) will be available as a private equity investment vehicle (on the new law, see developments in section I.A.1.3 above).

The Swiss investment LP will be required by law to serve the purpose of collective investments (mainly private equity investments) and will be a close-end vehicle. As a rule, it will be taxed like a contractual investment fund or a SICAV, i.e. in partial transparency (see above I.A.1.3).

In general, as the investors (limited partners) will not be considered to hold their investment in the Swiss investment LP in their commercial assets, the capital gains realised by the Swiss investment LP will in principle be tax-exempt. The income (distributed or retained) will however be subject to the 35% withholding tax and income tax, but not to “AVS” (social security contributions). The Federal Council has still to specify if a minimum number of limited partners in the Swiss investment LP will be required by law.

The general partner will have to be a Swiss joint stock company (SA), which will be taxed as such.

2. The Investor

The guiding principle for the taxation of a Swiss investor is generally taxation on all income with the exception of capital gains, which are exempt if belonging to his private assets. If the income was subject to the 35% withholding tax when distributed, the Swiss investor is entitled to a full refund at the time of submitting his income tax return. In the case of a foreign investor, the withholding tax is non-refundable unless a double taxation treaty or special provision of law applies.

As we saw above (section V.B.1), there are several different types of possible investment vehicles, both Swiss and foreign:

- a. investment via an investment company (based on company law):
 - i. investment company (corporation, legal entity)
 - ii. investment partnership
- b. investment fund

In substance, the tax consequences for the investor will therefore be as follows:

In the case of an *investment company (corporate-style)*, the profits are subject to economic double taxation. The capital gains are first taxed at the level of the investment vehicle (unless the conditions for the participation exemption are met, see V.A.2.2 above) and the investor is then taxed if dividends are distributed. If the company is a Swiss resident, the distribution is also subject to withholding tax at the rate of 35%, which is refundable only to Swiss residents (subject to income tax) or under a double taxation agreement. The capital gain made by the investor on the sale of its shares in the investment company (which, by hypothesis, retains its profits) is tax-exempt for the Swiss investor, if the shares belong to his private assets.

Investment partnerships are in principle tax transparent. Generally this investment vehicle is not subject to profit tax, but the investors are taxed. The vehicle's income is taxed in the hand of the partners, following the tax rules of such partners (i) for the applicable tax rate and (ii) for the qualification of such income (capital gain or income), unless by way of exception (for instance where the private assets of the Swiss investor are characterized as commercial assets, which can happen if the investment is not managed by a third party but by the partners).

Finally, an *investment fund* follows also the rules of the tax transparency. For Swiss funds, however, the tax transparency is only partial due to the 35% withholding tax deducted from the income, distributed or retained (see above I.A.1.3). The income/gain of the investment fund is characterized (capital gain or income) following the individual investor's income tax rules. A Swiss investor is tax exempt on capital gains generated by the fund provided (i) Swiss accounting rules or, for a foreign fund, the home country rules, are respected and allow to identify the capital gain, and (ii) the capital gain is paid out in the form of a separate coupon. In principle, the investment is not characterized as a commercial asset, because the management

of the investment fund is assigned to a third party (and not the partner) and the investor does not generally have any managing rights in the funds.

C. Persons involved in the management of the target/investment fund

1. Managers of the target/investment fund

In Swiss tax law it can be tricky drawing a distinction between the income from moveable property (tax exempt capital gain/taxable dividend) and the income from employment (subject to tax in all cases).

As far as managers of the target company are concerned (chapter V.A), a question may arise regarding the shares in the target company he or she has been granted at a preferential price. As for the fund managers (chapter V.B), an issue arises in respect of (i) the shares in the investment vehicle and (ii) the shares in the company of the general partner (who receives the performance fee and carried interest).

As a general rule, the principle of causality applies and the shares/options granted *as remuneration in kind for the activity carried out* are taxed as income from activity, whether employed or self-employed. In this case, and to summarise, for a Swiss resident employee (manager of the target company or fund manager), the shares/options are subject to income tax at the time of granting (difference between the fair market value/tax value of the shares and the paid/exercise price). The shares/options qualify for tax rebate if subject to a blocking period (around 6%/10% per annum up to a maximum of 10/5 years). Any capital gain made once these have been granted is tax exempt.

Besides, in addition to all the above mentioned issues, we have to mention the general problem of the characterization, by the Swiss tax authorities, of every capital gains realised by the person involved in the management of the target/investment fund as (taxable) capital gain from self-employed activity (so-called “professional security dealer”). In this case, the capital gains are subject to income tax, i.e. are taxed at a rate of up to 50% (social contribution included) in Switzerland.

2. Particular Case of the Seller who Remains Manager of the Target Company

For the seller who remains a manager (employee) of the target company, problems may arise when the seller receives earn outs, as a supplement to the selling price. By applying the principle of causality, it is generally possible to prove to the tax authorities that the additional sum paid as an earn out is a supplement to the selling price and as such generally represents a tax-exempt capital gain which cannot be added to the taxable salary of the employee making the sale.

D. Conclusion

Despite a few aspects which may pose problems from a taxation point of view, Switzerland's legislation is attractive for private equity transactions (acquisition of a Swiss target company by a Swiss or foreign buyer). The new Swiss limited partnership (due to come into force on 1 January 2007) will close a loophole, offering investors and managers, Swiss and non-Swiss alike, an investment vehicle generally adapted to their needs. However, the success of this new Swiss vehicle ultimately lies with the managers, as it will only be used if the tax benefits it offers to them are attractive in international comparison.