

# TAX News

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With ongoing changes both in national and international tax law, it is essential to keep an eye on new developments. The latest revisions and innovations are summarized below.

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## 1. International Tax Law

### 1.1. US Tax Developments

#### *US Sec. 965 Repatriation Provisions- Further Guidance Issued concerning Operation of the Legislation*

In late 2004 US Section 965 was enacted under the US American Jobs Creation Act to provide a one time only 85% dividends received deduction ("DRD") for repatriation of previously untaxed foreign subsidiary profits. As the legislation represented a new alternative to the long established foreign tax credit regime there was little guidance available as to how to actually perform the calculations needed. The IRS initially published guidance in early 2005 on certain aspects of the legislation but still left unresolved many key issues. Within the last four months the IRS has issued two sets of guidance concerning how the provisions of Section 965 are to be applied. This was on top of guidance already issued in January 2005 on selected issues. Companies now should have enough information to make a determination of the benefits of repatriation of

foreign subsidiary earnings under the Section 965 legislation. Specifically:

On May 10, 2005, the IRS released Notice 2005-38, providing the second round of guidance to U.S. shareholders electing to claim the 85% DRD under Section 965 for qualifying cash dividends received from controlled foreign corporations ("CFCs"). In very general terms, the notice addresses:

- The effect of M&A transactions on base period calculations and the APB 23 limitation (the notice provides that base period inclusions and APB 23 limitation are U.S. shareholder-level attributes. Thus, for example, a taxpayer's base period amount is not affected if the taxpayer disposes of CFCs whose dividends, etc., contributed to the base period amount);
- The effect of M&A transactions on the CFC related party debt calculation, as well as some more general issues with respect to that calculation (the notice provides that debt is measured on a gross, not a net, basis, that debt for these purposes does not include certain trade payables, and that the acquisition or disposition of U.S. shareholders may affect the calculation);

- The Section 78 gross-up issue (concerning the gross-up for foreign taxes claimed as a foreign tax credit, or “FTC”). As expected, the notice provides in effect that the gross-up is scaled back by 85%;
- The disallowance of allocable expenses (the notice provides that only “directly allocable” expenses are disallowed). Notice 2005-64, discussed below, also provides further guidance on this issue;
- Certain technical interactions between Section 304 and Section 965 (clarifying that Section 304 dividends can meet the chain dividend rule requirements). Section 304 creates a US tax fiction where, typically, sale by a parent corporation of “brother” subsidiary shares to another “sister subsidiary is re-characterized as a dividend transaction to the parent followed by a capital contribution of the brother shares to the sister company);
- Required distributions by disregarded entities (“DEs”) receiving CFC dividends (the notice clarifies a prior rule and allows disregarded entities to, for example, pay debt or interest, or purchase assets in order to meet the cash distribution requirement).

On August 19, 2005, the IRS released Notice 2005-64, providing guidance on the few remaining significant outstanding issues, primarily concerning the calculation of the foreign tax credit and alternative minimum tax (“AMT”), as well as guidance on determining the amount of disallowed expenses allocable to the nontaxable portion of dividends received. This guidance was necessary particularly as concerns calculation of the foreign tax credit and deductibility of certain expenses allocable to the dividend since the statute requires the FTC and allocable deductions to be scaled back to match the partial taxability (i.e., only 15% inclusion) of the gross dividend. To the relief of tax planners, the notice provides

that interest expense will not be treated as a directly allocable (and thus partially nondeductible) expense.

*Insightful Private Letter Ruling (PLR) 200525002 concerning Treaty interpretation for Group Financing Companies*

The IRS recently issued a PLR that could potentially be taxpayer friendly and which provided some insight into the IRS’ views on the Active Trade or Business (“ATB”) test found in the Limitation of Benefits (“LOB”) clause of most modern US Treaties.

While PLR 200525002 did not deal directly with the Swiss-US treaty, when compared to similar provisions in the Swiss-US treaty, including the 1997 protocol, the IRS analysis and favorable outcome would also seem applicable to Swiss finance companies under the Swiss-US treaty. In particular, the analysis in the PLR should provide some comfort in the case of Swiss Group financing companies that finance US group operations, as long as there are other active group nonfinancing activities conducted in Switzerland.

Note that PLRs are not precedential and thus can not be cited as authority for positions taken by anyone other than the person requesting the ruling. However, the discussions in PLRs can give insight into the IRS’ view on a particular technical issue.

Under most US tax treaties, a foreign recipient of a US source payment is generally not entitled to US treaty benefits unless satisfying one of the alternative tests listed in the relevant treaty’s LOB article. One such test is the ATB test. In the case of group financing companies, qualifying for treaty benefits under the LOB, including the ATB test, can be difficult since the making or management of investments for its own account is usually not considered to be the conduct of an active trade or business, an ATB test requirement. Also, the requirement that the US source income be derived in connection with, or

is incidental to, that trade or business can be troublesome.

In PLR 200525002, the taxpayer, “ForeignCo.”, a company organized and operating in an undisclosed country, (“country A”), provides group financing to US financing and operating affiliates as well as to other third country related party affiliates. Unable to satisfy other tests in the US-Country A treaty LOB article, the taxpayer sought to qualify for treaty benefit under the ATB test.

In substance, the IRS held that even though ForeignCo. was not itself directly engaged in the active conduct of a trade or business, ForeignCo. could be considered to conduct the active business activities of the country A operating affiliates. Effectively, ForeignCo.’s and US financing affiliate’s own assets, income and payroll are not taken into account because these activities do not constitute active trades or businesses. Instead, the focus of the analysis is on the activities of the country A and US operating affiliates. Concerning ATB test requirements that the US source interest income be derived in connection with the trade or business of the taxpayer’s finance business, and that the taxpayers’ business be substantial in relation to the US trade or business generating the interest income, the analysis again seemed to focus on the aggregate activities of the country A and US operating affiliates and ignored the activities of ForeignCo. and the US financing company.

In the case of the Swiss-US treaty, the revised memorandum of understanding (“MOU”) regarding the 1997 protocol to the treaty indicates that holding investments for one’s own account will not constitute an active trade or business. However, the MOU further indicates that a contracting state resident who is engaged in an active trade or business is entitled to treaty benefit if that person ‘(or a person related to that person)’ is engaged in an active trade

or business. The MOU also indicates that an item of income will be considered to be earned in connection with, or to be incidental to, an active trade or business if the resident claiming the benefits is itself engaged in business, *or it is deemed to be so engaged through the activities of related persons, . . . .* etc. The MOU discusses a favorable example where an item of income is earned by a contracting state person through a holding company entity in the other contracting state which is interposed between the taxpayer and the other contracting state operating affiliate.

Thus, this PLR may provide further comfort in terms of obtaining US treaty benefits in certain group company situations involving Swiss finance entities where the group also conducts other active activities in Switzerland.

#### *Update on US Section 163(j) Earnings Stripping Proposals*

There have been various proposals over the last few years to "tighten" or further restrict US tax deductions for interest paid by related US persons to foreign related parties under the existing US section 163(j) earning stripping rules. The Bush administration has tabled proposals over the last two fiscal years to restrict related interest deductions by various required adjustment mechanisms. Specifically, the proposals include:

- Eliminating the current 1.5-to-1 debt-to-equity safe harbor;
- Reducing the ATI limitation threshold to 25% of ATI for disqualified interest other than interest paid to unrelated parties on debt that is subject to a related-party guarantee ("guaranteed debt"); interest on guaranteed debt would continue to be subject to the 50%-of-ATI limitation;
- Limiting the indefinite carryforward period for disallowed interest to ten years; and
- Eliminating the three-year carryforward period for excess limitation.

These proposals would be effective on the date of first Congressional committee action on the proposal.

As with last year's proposal, the 2006 Budget proposal does not include the "worldwide leverage test" or the tailored debt-to-asset safe harbor ratio for selected asset categories that were included in the FY2004 Budget proposals. However, further modifications to the earnings-stripping rules may be proposed after the Treasury Department concludes its report to Congress on the effectiveness and deficiencies in the current Section 163(j) rules for addressing income-reduction opportunities, which was mandated by Section 424 of the AJCA, and is to be delivered by June 30, 2005. To-date, we have not seen any indication that the report to Congress on the effectiveness of current Section 163(j) was delivered to Congress, or that there are any active considerations being given to proposals to tighten Section 163(j). It is likely any discussion of budget proposals adversely affecting Section 163(j) will not take place until late in 2005, if at all this year.

## 1.2 Germany

### *The obligation to disclose shareholding interests takes shape*

By letter of 17.08.2004, the Federal Finance Ministry (BMF) defined in more detail the obligation to disclose shareholding interests. Any person who directly holds at least 10%, or indirectly at least 25%, of the capital of corporations, partnerships and bodies of assets, or who has spent at least 150,000 EUR to acquire all such interests, must disclose that fact to the Finanzamt (Tax Office). The letter goes on to deal with the compulsory disclosure of shareholding interests in **foreign** partnerships and the reporting obligation of credit establishments, financial service providers and insurance companies. To that extent, the disclosure obligations also apply to shareholding interests in Switzerland. The disclosure obligation must be satisfied by means of an officially prescribed form within **one**

**month** of the incorporation or acquisition of the participation.

*Investment tax act (InvStG): doubtful points and matters of interpretation*  
In a lengthy letter of 2 June 2005, the Federal Finance Ministry comments in detail on doubtful points and matters of interpretation relating to the investment tax act (InvStG) of 15 December 2003 (BGBl. I 2003, p. 2676, 2724). This letter seeks to clarify the scope of application of InvStG and the concepts used in InvStG. The clarifications of individual paragraphs of the investment tax act are likely to be of particular interest to Swiss banks too.

### *Tax amnesty: subsequent legal uncertainty in the case of foundations? Consequences of the ruling of the Financial Tribunal of Rhineland-Palatinate*

Despite all the critical voices, the tax amnesty turned out in the end to be an attractive source of additional revenue for the German tax authority. The originally planned total of EUR 5 billion was admittedly not collected. That is hardly surprising as this figure was based largely on budgetary policy considerations. However, with a total of **EUR 1.25 billion** the tax amnesty proved more successful than many experts had predicted. The fact that revenue did not in practice "flood in" on a scale similar to that following the Italian tax amnesty was also attributable to the substantially more complex determination of taxable income. In addition, many investors of black money have placed their assets, for reasons of discretion and concealment, in **foundation or trust structures**. This procedure in the first instance regularly creates liability for German gifts tax which in individual cases may amount to as much as 50% of the contributed assets. In the early months of 2004, the amnesty brought very sluggish results, but the Federal government went on to publish a list of questions and answers giving more far-reaching aids to interpretation as to the procedure to be adopted with such foundations. As a result in many cases no gifts tax was

found to be payable. The specific individual case was clarified under a **neutral preliminary enquiry** procedure with the German finance administration. The finance administration then indicated its position on this matter as a matter of course in writing.

However, the Finance Tribunal of Rhineland-Palatinate went on to publish on 5 April 2005 (4 K 1590/03) a first basic ruling on the transfer of assets to a foundation in Liechtenstein. According to that ruling, such a procedure is always liable for German gifts tax even though in the case in point under the terms of the Foundation "regulation", all the rights to the entire assets of the foundation and the earnings thereon accrued to the plaintiff for his lifetime. In addition, the plaintiff was also at liberty to amend the "Regulation" at any time. But the legal action met with no success. The fact that the plaintiff had disposal authority at all times did not mean that the foundation itself had no such disposal authority. The finance tribunal saw this as a legal position comparable to that arising when a donation is made with a discretionary reservation of a right of revocation and therefore decided that liability for donations tax would also be incurred in such cases. The German financial administration immediately responded to the subsequent uncertainty created as a result by issuing a press release. According to this text, **cases of tax amnesty are always covered by the protection of confidentiality** provided that a written opinion was sought through an anonymous preliminary enquiry.

#### *Incompatibility of the split corporation tax rate with European law?*

Once again, a German tax provision – even if it has already been abolished – is being reviewed by the European Court of Justice to decide whether it is compatible with EU legislation. In the CLT-UFA case, the Cologne-West Tax Office had requested the EU Court of Justice to rule on the potential incompatibility with European law of the split corporation tax rate under the imputa-

tion procedure which has been abolished since the 2001 assessment period. Background to the case: profits which had been earned in Germany by the business establishment of a company registered in a different Member State had been assessed for a fixed corporation tax rate of 42% without any possibility of an abatement; on the other hand, profits made by a company based in Germany, for example a subsidiary company, and paid out by that subsidiary company in full to its parent company based in another Member State, are only liable for a tax rate of (most recently) 30%. In his conclusions, the Advocate-General stated his view that it was incompatible with the freedom of establishment for a company based in another EU Member State to be refused a tax abatement for taxation of the profits of its independent domestic branch establishments from which it would have benefited if its activity had been pursued by a subsidiary company.

Tax decisions for EU/EEA companies with limited tax liability should – as far as possible – be held open by the appeal procedure up to the assessment period 2000 inclusive (date of the transition to the half-revenue procedure). For the German places of business of Swiss parent companies, the anticipated judgment is unlikely to have any immediate implications as Switzerland as a non-Member State of the EU is not concerned by rulings handed down by the EU Court of Justice on freedom of establishment.

### 1.3 Italy

#### *Current status of negotiations Switzerland – Italy*

Recent negotiations with Italy have focused on the application of the Agreement between the European Community and the Swiss Confederation providing for measure equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (hereinafter referred to as "EU-savings agreement") entered in force on July 1,

2005. Additional meetings in this connection as well as regarding the revision of the double tax treaty shall take place between representatives of both countries within the next months.

Based on negotiations with Italy on the application of the EU-savings agreement the following main trends on the interpretation of article 10 on exchange of information and of article 15 regarding dividends, interests and royalties between companies may be recognized.

Article 10 of the EU-savings agreement provides an exchange of information on conducts constituting tax fraud or the like. The Italian view – which is not shared by Switzerland – is that Art. 10 shall also be applicable on income covered by article 15 of the EU-savings agreement.

In connection with article 15 of the EU-savings agreement which grants – under certain conditions - the exemption from withholding tax on intra-group dividends, interest royalties Italy seems to interpret and apply these rules having regard to the EU Directives. Both countries have agreed on a relief at source rather than a refund procedure – as general rule. It seems that Italy – as Switzerland – will apply the "Denkavit" practice in connection with the two years holding period (guideline of Swiss Federal Authorities dated July 15, 2005, page 5). The interpretation of "tax exempt" on paragraph 1 and 2 of the abovementioned article is still matter of negotiations.

Negotiations with Italy have also focused on the double tax treaty and its relation to article 15 of the EU-savings agreement. At present Italy seems to share the Swiss view that the anti abuse regulations according to article 23 of the double taxation treaty shall not be applicable for payments under article 15 of the EU-saving agreement. However, also this matter shall be further discussed during the next negotiation meetings.

## 1.4 DTI CH-Spain

### *Withholding tax exemption on dividends, interest and royalty payments in relation to Spain*

With the entry into force of the agreement on the taxation of savings on July 1, 2005, Switzerland will in principle benefit from the applicability of the EC directives on exemption from withholding tax on dividend, interest and royalty payments between affiliated companies.

However, special transitional provisions apply in relation to a few countries. Spain, for example, required a modification of the double taxation treaty with Switzerland to stipulate exemption from withholding tax for cross-border dividend, interest and royalty payments between affiliated companies. This revision of the double taxation treaty was signed at the end of April 2005. The modified double taxation treaty and the relief from withholding tax liability on interest and dividend payments in relation to Spain are expected to become applicable on January 1, 2006. In the case of royalty payments, however, the relief from withholding tax will not become applicable on payments until July 1, 2011 at the earliest. However, complete exemption from withholding tax must first be approved by the Spanish and Swiss Parliaments.

## 1.5 Bilaterals II

### *Swiss – EU Agreement on Crossborder Dividends, Interest and Royalties*

#### *Switzerland issues long awaited guidelines*

On July 15, 2005, the Swiss Federal Tax Administration (SFTA) issued guidelines for the application of Article 15 of the Savings Agreement concluded between Switzerland and the EU (Swiss-EU Agreement) which entered into force on July 1, 2005<sup>1</sup>. Article 15

<sup>1</sup> Agreement between the European Community and the Swiss

of the Swiss-EU Agreement provides for the abolition of withholding taxes on cross-border payments of dividends, interest and royalties made between affiliated companies. This summary highlights the developments involving Swiss sourced dividends. Although the Swiss-EU Agreement also provides for the abolition of withholding taxes on interest and royalty payments, the guidelines are only applicable with respect to Swiss dividend withholding tax. Nevertheless, the guidelines may serve as an indication for interpreting Article 15 as a whole.

It should be noted that the guidelines are not binding on the tax authorities of the EU Member States as regards the various withholding taxes in the EU Member States. For this reason, the *Ernst & Young EU Champions Group* recently conducted a survey on the interpretation of Article 15 in the 25 EU Member States. This will allow Ernst & Young tax professionals to provide clients with a comprehensive analysis of Article 15 both for Swiss outbound and inbound dividend, interest and royalty income.

#### *Overview*

The Swiss-EU Agreement inter-alia grants Switzerland measures equivalent to those found in the EC Parent-Subsidiary Directive of 1990<sup>2</sup>. This implies that dividends paid shall not be subject to taxation in the source State where:

- the parent company has a direct minimum holding of 25% of the capital of a subsidiary for at least two years, and;
- both companies are subject to corporation tax without being exempted and

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Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (hereinafter: "Swiss-EU Agreement").

<sup>2</sup> Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

both adopt the form of a limited company, and;

- one company is a tax resident in a Member State and the other company is a tax resident in Switzerland, and;
- under any double tax agreements with any third states neither company is a tax resident in that third state.

These rules are without prejudice to the application of domestic or agreement based provisions for the prevention of fraud or abuse.

#### *Scope*

At the outset, it is worth mentioning that existing double taxation agreements between Switzerland and EU Member States which provide for a more favourable tax treatment remain applicable. In other words, taxpayers *retain the choice* of applying the more favourable treatment afforded to them by either the Swiss-EU Agreement or the relevant comprehensive tax treaty. The Swiss-EU Agreement is applicable to all dividend distributions. This is the case even if the dividends are based on reserves generated by a Swiss company prior to July 1, 2005 (so-called "old reserves"). In addition, the Swiss-EU Agreement is also applicable where a Swiss company might have previously changed its shareholders from one EU Member State to another and having obtained a ruling whereby "old reserves" would be subject to withholding tax as per the previous treaty rate.

#### *Dividends defined*

The term "dividends paid" is to be interpreted similarly to the OECD Model Tax Treaty with reference to the definition in the State of source of the dividends. This typically includes constructive dividends as well as liquidation dividends.

#### *Fiscal residence*

It has been confirmed that residence is to be determined by application of Article 4 of the OECD Model Tax Treaty as well as a relevant comprehensive tax treaty. In case of international double taxation, it is therefore the place of ef-

fective management which takes precedence.

#### *25% direct shareholding*

The parent company must have a 25% direct holding in the subsidiary. It therefore only applies to dividends paid by subsidiary companies to parent companies. The SFTA nevertheless accepts that the interposition of a partnership which is fiscally transparent should not jeopardize the application of the Swiss-EU Agreement. ***It remains to be seen, whether such fiscally transparent entity interposed needs to be located in one of the two states or whether transparent entities in a third country would also be acceptable.***

#### *Subject to tax*

Both the parent and the subsidiary must be subject to corporation tax without being exempted. It has now been confirmed that relief will be denied on the basis of the subject-to-tax requirement only if a company is totally exempt or almost totally exempt pursuant to a regime which is referred to as “tax holiday”. Relief should however be granted to all other non-exempt Swiss limited companies regardless of any corporation tax relief for which they might qualify under Swiss domestic legislation or administrative practice. Therefore, companies taking advantage of relief for qualifying dividends, holding company relief, mixed company relief or auxiliary company relief should all benefit from the Swiss-EU Agreement.

#### *Two year minimum holding period*

The parent company must have a direct minimum holding of 25% of the capital of a subsidiary for at least two years. It has now been confirmed that the Swiss-EU Agreement will apply even if, at the time the dividend is paid, the two year minimum holding period is not fulfilled. In order to ensure that the proper holding period is observed (due dates are determinant), if dividends are paid before the minimum period has expired, Swiss companies are required to pay the amount of Swiss withholding tax that would normally have been levied

in the absence of the Swiss-EU Agreement (Swiss domestic rate or treaty rate). Once the two year holding period has expired, this amount will be reimbursed by the SFTA upon request.

#### *Anti-abuse regulations*

The Swiss-EU Agreement is applicable without prejudice to the application of domestic or agreement-based provisions for the prevention of fraud or abuse, in Switzerland and in EU Member States. This is not an autonomous anti-abuse clause. It does not introduce an autonomous supranational concept of abuse, but refers to the application of existing provisions. The guidelines refer to the following without going into details: Beneficial ownership; tax fraud and fraudulent reduction of withholding taxes; abuse of law.

#### *Procedures*

Relief from withholding tax under the Swiss-EU Agreement is granted after filing a new Form 823C which remains valid for a three year period. Reimbursements of Swiss withholding tax, for example on dividends paid prior to the expiration of the two year holding period, are requested using a new Form 70.

#### *Benefits for the Taxpayers*

Dividend, interest and royalty payments frequently suffer a withholding tax in the State of source. In the past, relief has only been available by applying international tax treaty provisions. Although Switzerland has been favoring the payment of dividends, interest and royalties free of withholding tax in its recent treaty negotiations, there is nevertheless an unrecoverable withholding tax in the majority of Switzerland’s double taxation treaties. In these instances, Article 15 of the Swiss-EU Agreement will have the effect of facilitating the flows of cross-border dividend, interest and royalty payments between Switzerland and Member States of the EU. This may entail considerable overall tax savings. In some instances, intra-group restructuring may

be required in order to benefit from the new provisions.

Due to the favorable tax environment numerous Multinationals own their foreign subsidiaries through Swiss resident companies. As a result of Article 15 of the Swiss-EU Agreement no non-recoverable withholding taxes should result on qualifying dividend, interest and royalty payments. Therefore, the mentioned provision will further contribute to enhance the benefits arising from the use of the Swiss Holding Company regime (0% tax on qualifying dividends and 7.8% effective tax rate on qualifying net interest and royalty income) and foster Switzerland’s position as one of the premier locations for holding companies. Multinationals not already holding their investments through a Swiss based company should consider restructuring their shareholdings using a Swiss Holding Company.

## 2. Switzerland

### 2.1 Corporation tax reform II

#### *Introduction*

At the end of June 2005, the Federal Council adopted the draft law and the explanatory statement about corporation tax reform II.

The reform makes the following principal changes (although this list is not definitive):

1. Relief of double taxation of dividend payments
2. Statutory provisions for indirect partial liquidation
3. Statutory provisions on transposition
4. Statutory provisions on securities dealing by way of trade
5. Imputation of profits tax against capital tax
6. Facilitation of participation deductions
7. Abolition of employment creation reserves

Selected areas are discussed briefly below:

### *Partial taxation of dividends*

The profits of a business are liable for profits tax at the level of the company. If the company pays out profits to its shareholders, these dividends are taxable for a second time in that the shareholder himself is liable for income tax. Corporation tax reform II seeks to relieve this double taxation after pioneering work in this area had already been done by some cantons.

As far as the direct federal tax is concerned, corporation tax reform II introduces a partial taxation of dividends. The shareholder who has equities among his private assets now has a tax liability on **80%** of the resulting income, instead of 100% as in the past. Profits on the sale of shares remain tax-exempt. If the participations are held as part of the business assets, 60% of the income on shareholding rights is taxed after deduction of the imputable expenditure. 60% of the profits on the disposal of participations from business assets are also taxable if the participations represent at least 10% of the equity capital or ordinary capital of a joint stock company or of a cooperative (qualified participation) and if they were owned by the taxpayer or partnership for at least one year. Where a non-qualified participation (less than 10% of the capital of a company) forming part of the business assets is sold, the resulting capital gain remains taxable in full (100%). Shares in investment funds and organizational forms assimilated with them for tax purposes are excluded from these abatements.

An amendment to the Federal law on the harmonization of direct taxation at cantonal and local authority level (tax harmonization act, StHG) requires the cantons to provide relief for the double taxation of corporations and shareholders at the level of the shareholders themselves. The nature and scope of the abatement is left to the discretion of the cantons.

The 20% relief on dividends held in private assets is regarded as insufficient by economic circles. They are calling for a reduction to 50%, because that is the only way in which the reform

would have a noticeable impact on growth and therefore give the holders of participation rights a genuine incentive to draw dividends.

### *Statutory provisions for indirect partial liquidation*

According to the case law of the Swiss Supreme Court, indirect partial liquidation is deemed to occur when participation rights which form part of private assets are sold to a person to whom the book value principle applies (business assets) if resources are withdrawn from the acquired company or a reduction of substance takes place and if the vendor cooperates in this removal of corporate funds used to finance the purchase price with the purchaser and knows, or should have known, that these resources would no longer be returned to the company. The Supreme Court has further tightened up the practice of indirect partial liquidation in its latest rulings in that the embargo period of five years often applied by the cantons for the withdrawal of substance after a sale was regarded as immaterial. Consequently, any subsequent withdrawal of substance is deemed to be prejudicial, regardless of the time at which it occurs.

The practice of indirect partial liquidation is now to be codified as part of corporate tax reform II. The concept of the "substitute dividend" has been adopted. This means that 80% of the proceeds of the sale of shareholding rights held as private assets to a purchaser for whose taxation the nominal value principle does not apply, will be taxable unless the vendor held a share of at least 20% in the equity or ordinary capital of the joint stock company or cooperative. The proceeds achieved are taxable in every case in the amount of the net current assets and the net capital assets not required for operating purposes (after deduction for net inventories and similar assets and a small liquidity reserve), unless distributable reserves exist on an equivalent scale. This "substitute dividend" is taxable at the level of the vendor: if a private shareholder sells his participation of at

least 20% in a business to a partnership or a company, he must pay income tax to the extent that distributable resources which are not needed for operating purposes exist in the company which is sold.

For the purpose of determining whether indirect partial liquidation has occurred, in future therefore the capacity and conduct of the vendor will no longer be the decisive factors. According to the previous practice of the Supreme Court, the question as to whether the profit on the disposal of equities held as private assets was taxable as income depended on the financial resources of the purchaser. If the purchaser of the equities was a natural person or a wealthy legal person, the capital gain was tax-free. On the other hand, if the purchaser was a legal person who had to finance the equity purchase by borrowing, the profit achieved was liable in whole or in part for income tax. In future, the issue as to whether the purchaser and vendor jointly planned and implemented the removal of resources from the company will no longer be relevant. In future, the only determining factor will be whether the company has net assets which are not required for operational purposes and are eligible for distribution and whether the vendor had a determining influence on the distribution policy of the company concerned. The economic associations declined the planned new provisions in the form in which they were presented. Firstly, a shareholder with shareholding rights of just 20% will have difficulty in influencing the distribution policy and, secondly, the numerical determination of the distributable net current assets or net fixed assets will require a substantial administrative effort which is not feasible in practice. If this draft does become law it will affect in the first instance medium-sized entrepreneurs. Only careful tax planning will be capable of ensuring that the private vendor will be able to achieve a tax-free capital gain as used to be the case, as provided by Art. 16 para. 3 of the Federal law on direct federal tax (DBG).

*Statutory provisions on transposition*

Pursuant to the case law of the supreme court, a transposition is deemed to occur if a person transfers participations which he holds in his private assets at a value higher than their nominal value to a company which is controlled by him and the transferring person receives in return shares in the equity or ordinary capital and/or a credit note/cash payment. The difference between the sales proceeds and the nominal value is not qualified in this case as a tax-free capital gain but as a taxable dividend because the vendor is economically identical to the purchaser and therefore does not effectively dispose of his participation but simply “restructures his assets.”

Corporation tax reform II makes statutory provision for the circumstance of transposition. The new rule states that the proceeds of the transfer of participation rights to a company in which the vendor has a share of at least 50% in the equity or ordinary capital is taxable in the amount of 80%, provided that the equivalent consideration exceeds the nominal value of the transferred participation rights. The vendor is therefore liable for tax on the difference between the consideration received from the purchaser (nominal value of newly issued participation rights, cash, receivables) and the nominal value of the participations under the partial taxation procedure.

The decision as to whether transposition occurs will be guided solely by the criterion of the participation rate. If the participation of the vendor after the transfer amounts to at least 50% of the acquiring company the circumstance of transposition is deemed to exist.

*Statutory provisions on securities dealing by way of trade*

Pursuant to Art. 16 para. 3 DBG, capital gains on the disposal of private assets are not taxable. On the other hand, capital gains on the disposal, utilization or revaluation of business assets (Art. 18 para. 2 DBG) are taxable. Pursuant to the case law of the Supreme Court, this includes gains on securities, pro-

vided that the securities trade exceeds the scope of private asset management. Such securities dealing by way of trade is also covered by corporation tax reform II.

The new statutory provision stipulates that gains on the disposal of securities represent income from a self-employed activity and are therefore taxable if one of the two following conditions is satisfied:

The securities were acquired using borrowed capital representing at least 20% of the value and were held by the taxpayer for not more than five years or the annual sales proceeds amount to at least CHF 500,000 and the securities assets existing at the beginning of the tax year were traded at least twice. Previously under the case law of the Supreme Court and pursuant to a circular from the Swiss Federal Tax Administration, an assessment had to be made in each individual case on the basis of various subjective and objective criteria, as to whether private asset management or securities dealing by way of trade had occurred. The reform seeks to simplify this assessment by means of the two quantifiable alternative criteria. The first criterion in particular will soon lead to an extension of the circle of persons liable for tax. Given the volatility of the equity markets today, it will surely be difficult to expect the taxpayer to “sit on” his securities for a long period of five years.

*Conclusion*

The draft text of corporation tax reform II will be considered in the winter quarter of 2005 by the WAK Preparatory Commission (Commission on Economic Affairs and Taxation). Examination by the National Council and Cantonal Council is unlikely to take place before the 2006 spring session. We await the outcomes and implementation with keen interest.

## 2.2 Supervisory Commission

The time limit for bringing cantonal legislation into line with the requirements of the Federal Act on the Har-

monisation of Direct Taxation of the Confederation, Cantons and Local Authorities expired at the end of 2000. In early 2002, the Commission on the Harmonisation of Direct Taxation of the Confederation, Cantons and Local Authorities (KHSt) instructed the Swiss Tax Conference (SSK) to submit a report on the status of tax harmonisation achieved in Switzerland by 2001. The SSK went on to entrust its Commission on Legislation and Harmonisation with the necessary work. On the basis of that report, a need for action in respect of the verification of cantonal tax law clearly emerged. On 19 September 2003, the Executive of the Conference of Cantonal Finance Directors (FDK) instructed the KHSt to appoint a committee of experts on the implementation and enforcement of tax harmonisation. Its task was to develop principles for cooperation on the harmonisation of direct taxation and legal measures and the necessary infrastructure for implementation and enforcement of the formal harmonisation of direct taxation between the confederation and cantons under shared responsibility. At the end of May 2004, the Committee of Experts submitted its report. Agreement was reached between the Committee of Experts, FDK and KHSt to the effect that formal tax harmonisation is an ongoing process which must be pursued and developed further. The Committee of Experts reached the conclusion that the implementation of the Tax Harmonization Act (StHG) is now reaching its limits and that in practice there are supervisory gaps, especially in the area of the privileged treatment of taxpayers by the adoption of rulings which are incompatible with StHG. Particular complaint was directed at the “supervisory gap” which exists in such cases, because neither a cantonal court nor the supreme court – in the absence of an appellant – can verify the compatibility of a cantonal regulation or practice with the StHG; for this reason, the implementation of the StHG is weakened and in the last resort the equality of the cantons is called into question. Ultimately, the issue is the admissibility of

tax competition between the cantons which was never contested when the StHG was adopted.

On April 13, 2005, the Federal Council took note of the report and resolved to lay it open to further consultation. The consultation procedure ended on August 15, 2005.

In its report, the Committee of Experts recommends the creation of a supervisory commission which will, in particular, verify the cases in which the cantonal legislation or practice is advantageous to natural legal persons who are taxpayers in the canton to determine their compatibility with the Tax Harmonisation Act. This supervisory commission is (in principle) to be independent but attached for administrative purposes to the Federal Department of Finance. The five to seven seats on this "specialised body" will be filled by representatives of the confederation and cantons. However, there will be no representatives of economic interests. The activity area of the supervisory commission is twofold: in non-contentious proceedings which may be initiated on its own initiative or at the request of certain entitled parties (confederation, canton or FDK) and by third cantons, it will have a review function in respect of general-abstract cantonal decrees or verify the practice based thereon (interpretation) for its compatibility with the StHG. It will clearly not be dealing with individual tax procedures and will not be able to take decisions on the lawfulness of an assessment ruling. The question now arises as to how this can be achieved in the review of cantonal practice without direct reference to individual tax procedures. The supervisory commission has no autonomous decision-making authority, but must prepare an opinion for the attention of the canton concerned which the latter may either accept or reject. The canton concerned has the possibility of proposing an agreed solution to the supervisory commission with a view to the restoration of a situation complying with the federal law and implementing that solution within six months of the publication of the opin-

ion. The supervisory commission has the right in relation to the confederation and canton concerned to bring a decision issued under the non-contentious procedure as a lawsuit before a cantonal judicial authority and may go on to make an administrative court appeal up to supreme court level.

The purpose of legal harmonisation is to approximate the tax regulations of the confederation, cantons and local authorities by means of indirect legislation in respect of direct taxation. Within certain limits, the confederation has the right and the duty to supervise compliance by the cantons with the federal law. However, in practice implementation of the federal law remains the ultimate responsibility of the cantonal administrative and judicial authorities. To that extent, a general review of the administrative practice from the constitutional angle is certainly critical. However, the confederation has adequate instruments of supervisory law at a different level, such as the issue of circulars, instructions, inspections and in extreme cases automatic enforcement. The purpose of these instruments is to ensure that, in the performance of their tasks in their own autonomous area of responsibility, and in particular in the sphere of legislation, the cantons do not interfere with the competences of the confederation or breach the general framework of federal law.

### 2.3 Hidden capital contribution - Corporate income tax

The Federal Supreme Court had to deal in its important court decision of March 11, 2002, with the corporate income tax treatment of a hidden capital contribution respectively of a hidden agio. The court decision at hand gives reason to critical considerations in particular as regards the corporate income tax considerations of the Federal Supreme Court.

#### *Facts*

Three shareholders, individuals, incorporated Holding AG. The share capital

of Holding AG of TCHF 100 was paid in by contribution in kind of a participation in another corporation, whereas the formally contribution value of the participation corresponded to the nominal value of the shares of the participation brought in of TCHF 250 ("Transponierung" / so-called agio-solution). The Swiss Federal Tax Administration (hereinafter referred to as "FTA") determined as assessment basis to levy stamp duty a fair market value of the participation brought in of TCHF 2'000, whereas the difference of TCHF 1'750 was qualified as an allowance of the shareholders.

Thereupon Holding AG increased the book value of the participation up to TCHF 2'000, whereas the "revaluation amount" of TCHF 1'750 was credited to a "revaluation reserve". Within the assessment procedure of the federal income tax the accounting transaction was qualified as taxable revaluation profit, whereas an additional profit of TCHF 1'750 was added up and subsequently taxed as business profit. Holding AG appealed unsuccessfully against that add up of profit. The recourse against the appeal decision was approved by the cantonal administration court on the grounds that obvious offences against mandatory commercial law result in a duty to correct the balance sheet. Against this decision the FTA recurred successfully at the Federal Supreme Court.

#### *Considerations of the Federal Supreme Court*

As to the corporate income tax considerations the Federal Supreme Court commented, that the approved financial statements of Holding AG are bindingly to the tax authorities by reason of the authoritative principle ("Massgeblichkeitsprinzip"). The allowance of the shareholders subject to stamp duty has to be qualified as hidden capital contribution as regards federal income tax. Thereby the tax authorities basically abstain with regard to corporate income tax from adjusting and revaluating the undervalued participation brought in; whereas they rely on the

purchase price concluded between the parties to the contract according to civil law and do not tax for the time being the hidden reserves. However, the Federal Supreme Court takes up the position that the company has to persist in the future to the book values chosen and the respective undervaluation according to the authoritative principle. In particular it is not able at the time of realisation of the silent reserves to escape from a realisation of profit and a respective taxation due to historical arguments. The redesign of the balance sheet – adjustment of the book value to the fair market value of the participation – is in accordance with the fiscal evaluation principles. Thereby Holding AG has subjected the hidden capital contribution itself to corporate income taxation. Likewise it can not depend on if a posterior renaming of the “revaluation reserve” in “agio from capital contribution” effectively corresponds to an adjustment of the original book entry.

#### *Previous code of practice of the FTA*

According to the effective practice of the FTA previous to the highest-court decision a corporation can not reveal a hidden capital contribution by a private shareholder tax neutral in the balance sheet for tax purposes, even though it is unanimously required by the doctrine. After all the company is allowed to reveal the hidden capital contribution in the commercial balance sheet of the business year in which it took place and to book the activated amount tax neutral as agio (tax neutral revealing of a hidden agio).

#### *Corporate income tax analysis of the decision of the Federal Supreme Court dated March 11, 2002*

According to Art. 58 para. 1 lit. a of the Federal Law on federal direct tax (hereinafter referred to as “FLFDT”) the net profit of a corporation is composed of the balance of the income statement in consideration of the account carried forward of the previous year, whereby the authoritative principle of the commercial balance sheet is derived from. However, the

authoritative principle is not to be understood as absolutely, as the authoritative taxable profit of a corporation corresponds to the income statement conformable to commercial law taking into account the fiscal adjustments (rectification of the balance sheet / correction of the balance sheet). The authoritative taxable profit of a corporation corresponds basically to the asset profit (“Vermögensstandsgewinn”) that is the difference between the equity of the corporation at the end of the current business year and the equity at the end of the prior business year. However, there are circumstances that result in an increasing of the asset profit but represent from a corporate income tax point of view a tax neutral transaction. In particular capital contributions from shareholders are tax neutral and not part of the taxable profit. According to Art. 60 lit. a FLFDT this applies also to extra payments and “à fonds perdu” benefits by the shareholders. They are motivated in the relationship between the shareholders and the corporation and are not a result of the commercial activity, whereas they do not belong to the taxable profit of the corporation.

According to the main opinion of the doctrine, the authoritative principle should not be applied with regard to hidden capital contributions. Commercially it is undisputable that open as well as hidden capital contributions are not part of the profit of a corporation as the corporation should only be taxed for the self generated profit, whereas also the constitutional principle of economical efficiency (“Leistungsfähigkeitsprinzip”) has to be observed. Fiscal adjustments of the commercial balance sheet causing an add up or a reduction of profit and that offend against the authoritative principle should not only be carried out in disfavor but also in favor of the corporation subject to corporate income tax. Hidden capital contributions out of the private wealth should therefore be evaluated from a fiscal point of view at fair market value. The question, at what point of time the hidden capital contribution is to be re-

vealed tax neutral in the balance sheet for tax purposes, is discussed contradictorily in the doctrine. One opinion argues that the tax neutral revealing should be exercised at the point of time of the capital contribution. Sometimes it is argued that the corporation may rely on the capital contribution at a later year whereas the commercial balance sheet can be modified without triggering any tax consequences respectively the capital contribution can be revealed tax neutral.

#### *Conclusion*

The cited decision of the Federal Supreme Court is to be analyzed critically. On the one hand the Federal Supreme Court has only given superficially attention to the authoritative principle even though the case at hand deals with a question of principle with regard to corporate income taxation. On the other hand the decision violates the constitutional principle of efficiency. Furthermore the Federal Supreme Court does not assess the taxability of hidden capital contributions with respect to Art. 60 lit. a FITC, whereas capital contributions including extra payments and “à fonds perdu” benefits do not constitute taxable profit. Last but not least the Federal Supreme Court does not go into the previous effective practice of the FTA.

With regard to the corporate income tax considerations of the case by the Federal Supreme Court it is to be expected that the present decision is nonrecurring.

### 3. VAT

#### *Unitary tax rate*

Federal Counciller Hans-Rudolf Merz announced in August 2005 that the simplification of the VAT system is of top priority to him. In order to reach this goal, Mr. Merz would like to introduce a unitary tax rate and abolish the 25 exceptions (tax exemptions without credit). The new unitary tax rate should be lower than the current standard tax rate of 7.6%. The

respective consultation procedure should start no later than this winter.

#### *Drafts of new VAT publications*

The VAT main division of the Federal Tax Administration (FTA) is currently adapting all the VAT publications (booklets, leaflets) with the goal of optimizing the usefulness and convenience for the VAT liable persons. The volume of VAT publications to be used by a tax liable person in the daily business shall be reduced. For small and middle enterprises (SME), a shorter guide will replace the Guidance 2001 for VAT liable persons. As complement to this guide, leaflets will further on explain sectoral VAT problems. For larger companies and for tax consultants, the FTA will release a very detailed Guidance.

The draft version of the short guide – for taxable persons who declare the tax based on the effective method and for those with the balance tax rate method – are currently published under [www.estv.admin.ch/data/mwst/d/mwst-kg/entwuerfe.html](http://www.estv.admin.ch/data/mwst/d/mwst-kg/entwuerfe.html).

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