

Tax News

December 2006



Dear Reader

Welcome to the December issue of Tax News. Amongst international and national tax developments, we would also like to inform you about the latest findings from the Ernst & Young Swiss Attractiveness Survey. The survey was conducted to investigate why more and more international companies are choosing Switzerland as the place to establish independent headquarters or principal companies within Europe, i.e. what is it that continues to make Switzerland so attractive for new business.

The study involved examining three major elements: The first entailed providing an analysis of facts and figures regarding Switzerland as a market, its location within Europe and labor supply. The second was to review the results of Ernst & Young's ongoing survey of foreign direct investment (FDI) into Europe, and the third was a survey conducted amongst international executives now working in Switzerland.

When examining the facts and figures it becomes clear why Switzerland is nearly always at the top of any international comparison: Its fundamentals regularly achieve top ratings due to long-term stability, the protection of free competition whilst ensuring the continuation and expansion of its trade and investment relationships with the EU (through bilateral agreements), etc.

Switzerland's geographical position is also an advantage, lying in the heart of Europe providing easy flight access to the Americas, Asia Pacific and Africa. In fact no other country can boast claim to

such multiculturalism with four official languages spoken (German, French, Italian and Romansh) together with English as a business language. Switzerland has an excellent long-term track record for political and economic stability with a reputation of being a mature and global financial center, all of which make the choice for Switzerland an easy one.

Its largest two cities, Zurich and Geneva, consistently rank highly for quality of life in the annual survey conducted by Mercer. In addition, according to a recent UBS survey inhabitants of Geneva and Zurich enjoy, although being among the world's most expensive cities, some of the highest buying powers from among 70 global cities surveyed. The Swiss labor force is well known for being highly skilled, multilingual, producing good quality work and having low absentee rates, which together with Switzerland's flexible labor legislation provides companies with an attractive position. Switzerland's infrastructure is also well known for being reliable, timely and having the latest technological advances.

Previously the key reasoning given by executives behind choosing Switzerland as a location for business had been the favorable tax environment and tax incentives offered, however the Swiss Attractiveness Survey results clearly show there has been an increased importance of other elements which now too play a fundamental role in the determination of a location for foreign investment. Factors such as quality of life, political stability, flexible labor laws, social environment, infrastructure, location within Europe

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and the labor market are now also seen as important decision-making criteria.

A copy of the Swiss Attractiveness Survey can be downloaded from the Ernst & Young internet site at:

<http://www2.eycom.ch/media/mediareleases/releases/20060929/en.aspx>

In the name of Ernst & Young, I wish you and your family a happy holiday season and look forward to keep exchanging knowledge, thoughts and ideas with you in the new year.

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US Releases New Model Treaty and Technical Explanation

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On November 15 the US Treasury Department issued new versions of the US Model Income Tax Convention (US Model Treaty) and Model Technical Explanation (TE). The Treasury Department indicated that the 2006 Model Treaty will be used as the basis for future bilateral treaty negotiations. The US Model Treaty and TE had not been updated since 1996 and thus these two documents reflect the many changes in US domestic tax law and policy. As a practical matter, many of the changes have already been reflected in recent US agreements such as the recent tax treaty protocols with Sweden, Denmark, Finland and Germany.

Some of the most notable changes and highlights include:

- Updated dividend article (but with NO 0% withholding tax provision for parent-subsidiary dividends)
- Updated interest article, including a 15% withholding tax on “contingent interest”
- New article specifically addressing pension funds
- Revised Limitation of Benefits (LOB) article (but with NO “triangular” provision included)

Of note, the revised TE includes multiple examples addressing dividends paid to fiscally transparent and hybrid entities, and a discussion of guarantee fees in the “other income” explanation. Discussion of treaty benefits to dividend payments to transparent and hybrid entities has become very relevant especially since the US introduced the “check-the-box” entity classification rules in 1997.

The most significant revisions to the Model Treaty relate to the LOB article. It is unclear why there is no “triangular” provision in the LOB (where treaty benefits

are reduced or denied when the income is earned through a typically low/no tax permanent establishment in a third country) although most recent treaty protocols, as well as the current US-Switzerland treaty LOB article, have included such provisions. Also interesting is that there is no derivative benefits provision included in the revised LOB article, but this might be explained as only being appropriate to treaties with countries that are part of formal integrated trading blocks, such as NAFTA and the EU. Certain other tests in the LOB article were also revised, including the publicly traded test, the “subsidiary of a publicly traded company” test, and the ownership/base –erosion test.

Further US Treaty Developments

Of particular interest to the Swiss business community are the developments concerning US tax treaties with other European countries, given the importance of the US markets to Switzerland. Recent US-European treaty developments have included:

- The initial agreement for a new US-Belgium treaty, including a 0% dividend withholding tax on parent-subsidiary dividends paid from the US (as also found in recent Netherlands, Germany and Sweden treaties or protocols). (This compares to 5% under the current US-Switzerland treaty.)
- The US Treasury Department announced September 28 that the US and Iceland had initialed a new tax treaty. Of particular importance is that the new treaty (the text is not yet available) will contain an LOB article. This continues the US trend to renegotiate all older US treaties that do not contain a comprehensive LOB article to help eliminate perceived “treaty shopping.» The other

remaining “older-style” treaties include the treaties with Hungary and Poland – both are currently under renegotiation.

US Plans to Eliminate Interest for “Cured” Withholding Tax Failures

On October 27, the IRS issued Notice 2006–99 indicating the government’s intention to retroactively revise existing withholding tax regulations under Internal Revenue Code Section 1441 (the primary withholding tax section). These regulations imposed interest and penalties for failure to withhold US taxes where there was no underlying tax liability due, but will now not impose interest and penalties in such situations. The provisions in question typically concern a withholding agent (in most cases, the payor) that had failed to follow appropriate documentation or withholding tax procedures at the time the payment to a non-US person was made. In many instances, withholding agents obtain documentation supporting reduced or eliminated US withholding taxation after the payment, thus retroactively eliminating the underlying tax liability.

Under the existing regulations, interest and penalties were due from the withholding agent even if the underlying tax liability was retroactively extinguished. The announcement represents a big change for the IRS and will bring relief for many US payors of US source interest, dividends, and royalties for use of intellectual property. In many cases interest and potential penalties that could have been assessed were often significantly larger than the tax ultimately owed after the collection of cure documents. ■

Increasing Attention and Awareness on Transfer Pricing Issues by Multinational Enterprises and Tax Administrations Worldwide

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Since 1995, Ernst & Young (E&Y) has been conducting surveys with multinational enterprises (MNEs) and tax administrations on worldwide international tax matters, in particular with a special emphasis on what continues to be the number one international tax issue of interest to both these parties: transfer pricing.

This importance appears to be driven mainly by several factors, i.e. growth in the number of countries that now focus more attention on transfer pricing activity, the increase in the number of countries introducing transfer pricing documentation requirements and penalty rules, and the diversity of transfer pricing issues facing MNEs and tax administrations.

In the previous two installments of the E&Y Global Transfer Pricing Surveys, general information regarding the transfer pricing environment from the perspective of the MNEs was provided.

The surveys indicated that more than 90% of the respondents have identified transfer pricing as most important agenda of the MNEs' corporate tax directors, and over 80% of the MNE respondents believe an audit on their transfer pricing structures is likely within the next two years. Over 60% of Swiss MNEs have also started to concentrate on developing a global transfer pricing documentation for their transfer pricing structures. The main reasons for doing this would be to identify tax planning opportunities, consistency in the application of the transfer pricing structures on a Group-wide basis, which has an effect on cost efficiency, and most importantly to manage the tax risks of the Group

by being compliant with the transfer pricing rules and regulations set by the tax administrations. Indeed, the MNEs expect the level of challenge to increase in coming years, and they are increasing their efforts to defend against these challenges. However, there is a clear expectation that it is not possible to achieve complete protection. This is evidenced by the fact that over 50% of the respondents now set aside a provision for transfer pricing risk in their financial statements.

In the last installment of the E&Y survey, information obtained from the interviews with tax administrations from 39 countries regarding the future plans, perceptions and developments was provided. As stated in the last installment of the survey, "the pace and significance of changes within the tax administration environment simply cannot be overstated. These changes in legislation, attitude, and approach have a major impact on MNEs as they seek to manage their tax risks and meet their transfer pricing obligations around the world. Furthermore, the survey indicates that there is a trend in growing divergence in the approach to transfer pricing, not only between MNEs and tax administrations, but also amongst tax administrations themselves." Some of the key recent global findings arising from the last survey include, amongst others:

– *Changing Environment* – there are more countries coming into the transfer pricing environment, and furthermore those countries with more established regimes are making major changes in their approaches;

– *Risk Management* – tax administrations will be increasing their focus on business practices and industries where they perceive the greatest risk of revenue leakage;

– *Trends* – although there is more cooperation among tax administrations, one trend that is emerging is a degree of divergence in approach between countries, even where there is apparent agreement on the principles. This trend will challenge the resolution of bilateral disputes;

– *Tax Authority Approaches* – there is some evidence of increasing sophistication in data gathering by tax administrations to augment their enforcement efforts. The tax administrations are capable of examining more complex transactions as they recruit and train specialist resources.

There is no doubt that the level of growth in the number of MNEs being audited and assessed has been on the rise of late. According to the E&Y survey, over 60% of the MNEs surveyed have undergone a transfer pricing audit in the last three years, of which over 40% have resulted in tax adjustments. Based on a recent article dated November 8, 2006, "Cross-Border Assessments Up 30%, Deficiencies Up 24.7%", it was mentioned that Japan issued 30.3% more cross-border deficiency assessments in the 2005 tax year than the year before. The number of assessments – 885 in 2005 compared with 679 in 2004 – brings the overall amount of deficiencies to approximately USD 4.4 bil-

lion. Additionally, there has been a rise in the application of penalties in Canada, New Zealand, and other countries. An increase in transfer pricing litigation cases is heading to the courts in the UK, and large and increasing transfer pricing revenue yields were reported by some countries such as Brazil. These trends indicate that there is a need for MNEs to revisit their transfer pricing structures. Such a notion gives clear warning that tough, turbulent times are fast approaching in the area of transfer pricing. ■

Germany: New Details on Cornerstones for 2008 Business Tax Reform

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On November 2, 2006, members of the German Federal and State Conference Committee responsible for the reform of business taxation agreed on cornerstone elements for a 2008 Business Tax Reform (note: the agreements include only proposals, which have not been worked out in any technical detail, a factor that indicates that revisions before final implementation are likely). Through a reduction in tax rates and a simultaneous broadening of the tax base, the reform is intended to reduce the tax burden on corporations by an approximate net EUR 5 billion. In addition to making Germany a more attractive place to do business, the reform aims to tax corporations and partnerships in a similar manner irrespective of their legal form or financing. The cornerstone elements for a 2008 corporate tax reform include (as at November 2, 2006):

Tax reduction elements:

- The corporate tax rate would be reduced from the current 25% to 15%.
- The trade tax base rate (i.e. the factor by which the municipal factor rate is multiplied) would be lowered from 5% to 3.5%.
- There would be better opportunities to set off trade tax against income tax for natural persons.
- The tax burden on partnerships and corporations would be harmonized.

- The regulations on special and investment reserves to boost SMEs would be revised.
- A settlement tax of 25% on investment income and private capital gains (especially on securities, investment fund units, shares in corporations) would be introduced as of *January 1, 2009*; correspondingly, the possibility of enquiring bank accounts for tax purposes would largely be dropped.

Tax revenue raisers:

- Trade tax would no longer be deductible as a business expense.
- The current thin capitalization rule would be replaced by a general interest limitation rule.
- The current 50% add back of interest on long-term debt for the calculation of trade tax would be replaced by an add back of probably 25% of all interest cost (long-term, short-term), the embedded financing element in lease and royalty expenses, etc.
- Rules concerning the computation of taxable gain stemming from the transfer of business functions abroad would be sharpened.
- The ways that securities lending may be structured would be restricted.
- Limitation of loss carry forward of shell companies (current rules apply only to direct transfer of more than 50% in a

loss entity, combined with a subsequent “stuffing” of the loss company with new assets).

- The current possibility to depreciate moveable assets on a declining balance depreciation convention would be abolished.
- The current possibility to fully depreciate low-value items in the year of acquisition would be limited.

The planned reduction in corporate tax rate and the introduction of a settlement tax are pointing the right way. The planned forms of relief will totally reduce the tax burden on German corporations from approximately 38.6% to some 29.8% from 2008 onwards and enhance Germany’s tax competitiveness. The legislative process is due to end by summer 2007. ■

Amendment to Double Taxation Agreement with Finland Comes into Force

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A protocol to amend the double taxation agreement (DTA) between Switzerland and Finland of December 16, 1991, entered into effect on December 1, 2006. The amendment takes account of a change in Finnish law, and of the need to implement the provisions of the Agreement on the Taxation of Interest between Switzerland and the European Union of October 26, 2004. The protocol is concerned in particular with changes to the taxation of dividends paid to holding companies, the exchange of information and mutual administrative assistance.

Under Art. 10 para. 2 of the DTA, dividends can be taxed in the contracting state of the paying company up to 10% of the gross dividend payment. However, if the recipient is not a partnership and holds a stake of at least 20% in the paying entity, the income can now only be taxed in the contracting state of the recipient. In contrast to the Agreement on the Taxation of Interest, there is no two-year minimum holding period and the required shareholding is 5% lower.

Information can now be exchanged between tax authorities through administrative assistance channels, and this infor-

mation can also be used for tax assessments. The two contracting states have also undertaken to provide administrative assistance on request in order to implement national law in the case of holding companies pursuant to Art. 28 para. 2 of the Law on Tax Harmonization (StHG); in terms of content, however, this is limited to information that is already on file. Finally, the countries are now also required to provide administrative assistance in cases of tax fraud.

Finland's Taxation of Expatriates for Three Years after they Left the Country has been eliminated

The changes set out in the protocol will enter into effect on January 1, 2007. The tax-at-source on dividends paid to holding companies that own at least 20% of the paying entity is being reduced with retrospective effect as from January 1, 2006, to a residual rate of 0%. ■

Federal Direct Tax Relief – New Federal Government Regional Policy

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In a final vote that took place on October 6, 2006, both chambers of the federal parliament approved the *Bundesgesetz über die Regionalpolitik (NRPG)* (Swiss Federal Regional Policy Act), which is due to come into force at the beginning of 2008. The referendum period expires on January 25, 2007.

The federal government regional policy bill has five parts, i.e. the NRPG plus four other bills, which extend the expiring federal regional policy decrees until the NRPG comes into force by 2008 at the latest. According to the bill, any tax breaks will depend on criteria such as the number of new jobs created, the extent of planned investment within areas of economic renewal (“*wirtschaftliche Erneuerungsgebiete*”), and volume of turnover. The latter includes: purchases and orders (made or planned), or services required from suppliers or businesses within such areas, or collaboration with research institutes and educational establishments which are directly linked to the proposed project.

During the preparation and discussion of the government’s new regional policy, the Federal Council and parliament confirmed that current institutional arrangements for tax breaks which are accorded to companies setting up business, should be retained in order to preserve Switzerland’s international competitiveness as a business location. It has not yet been decided which areas will qualify as future renewal areas. This will be determined by the federal government and the cantons working in close consultation with one another.

A provision subsequently added to the *Bundesgesetz über die Änderung des Bundesbeschlusses zugunsten wirtschaftlicher Erneuerungsgebiete* (“Lex Bonny”) (federal law concerning amendments to the

Federal Council decision favoring areas of economic renewal) confers powers on the federal government to grant tax relief, provided that tax relief has been granted at cantonal level pursuant to Art. 23 (3) of the *Steuerharmonisierungsgesetz* (Swiss Tax Harmonization Act). The cumulative requirements for industrial companies and production-related service enterprises under Art. 12 (2) NRPG are that they create new jobs or preserve existing jobs and that projects meet the requirements of regional economies under the NRPG. Additionally, cantonal tax relief may only be claimed with the understanding that any relief wrongfully claimed must be repaid. This means that divisions of legal entities which have their head office outside the assisted area can benefit from tax relief as well as legally separate entities.

The cantons are still responsible for granting cantonal and municipal tax relief, as was the case under the old law, which remains in force for the time being. For the purposes of federal tax law, the State Secretariat for Economic Affairs (SECO) is responsible for deciding, on behalf of the Federal Department of Economic Affairs, whether to approve an application by the cantons for tax relief and the extent of such relief.

Developments in Federal International Tax Law

Over the last few months, the Federal Council has submitted a number of double taxation agreements (DTAs) to the federal parliament for approval, including DTAs with Algeria, Armenia, Azerbaijan, Estonia, Finland and Pakistan. The recently negotiated protocol and additional protocol to the DTA with Spain and the new protocol to the DTA with Argentina are of particular significance.

On June 29, 2006, Switzerland ratified the amending protocol and additional protocol to the *DTA with Spain*. On September 6, 2006, the Federal Council submitted this to the federal parliament for approval along with its related message. The amending protocol makes substantial changes to the DTA and includes provisions on residual withholding tax on dividends, interest and royalty payments, a new anti-abuse provision and a wide-ranging mutual assistance clause. The article on dividends has equivalent effect to Art. 15 of the agreement between the European Community and the Swiss Confederation providing measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments (the “Taxation of Savings Income Agreement”). Residual withholding tax of 10%, which formerly applied, will be abolished once the amending protocol has come into force, provided that the beneficiary company has held 25% or more in the company paying dividends for a period of at least two years. The equivalent effect of the provisions of the DTA and Taxation of Savings Income Agreement has the advantage for Switzerland that the DTA will continue to exist whatever happens to the Taxation of Savings Income Agreement. Unlike Art. 15 of the Taxation of Savings Income Agreement, the DTA generally assigns the right to tax interest payments to the country of residence of the beneficiary of the interest. However, the provision concerning royalties is considerably narrower, as the DTA does not confer the exclusive right to impose tax on the beneficiary country.

The amending provision also stipulates that the company paying dividends, interest or royalties has unlimited tax liability and is not exempt from tax. In addition,

both limited companies must be based in either of the contracting states and not in a third country pursuant to a DTA. In order to claim treaty benefits for interest and royalty payments, the companies must either be affiliated with one company owning at least 25% of the other company, or a third company must have a direct equity interest of at least 25% for a period of at least two years in each of the two companies.

Switzerland meets its obligations which are based on the agreement with the European Union by introducing the new mutual assistance clause. According to this undertaking, DTAs must include provisions designed to facilitate the exchange of banking information in cases of tax fraud and similar offences to assist the country submitting the request in enforcing its national tax law. The mutual assistance clause also provides for the exchange of information on holding companies to ensure the proper application of national law.

The amending protocol, minus the royalty provisions, comes into force three months after notification that the approval process had been completed. The provisions concerning royalty payments are due to come into force on June 30, 2011 (six years after the Taxation of Savings Income Agreement takes effect), following a transition period.

The *DTA with Argentina* dated April 23, 1997, was not ratified by the Argentinian Congress and so never officially came into force. However, even though the agreement has no formal legal effect, it was implemented on a provisional basis pursuant to an agreement entered into November 23, 2000. To prevent the termination of the DTA, Switzerland eventually acceded to Argentina's request to resume negotiations. The new protocol, which was ratified on August 7, 2006, now includes the power to levy Argentinian withholding tax on royalty payments. On this basis,

withholding tax of 3% is payable on fees charged for the use of news items, 5% on copyright royalties, 10% on gross fees for patents, trade marks and leasing arrangements and 15% in all other cases. The DTA protocol also contains provisions on the Argentinian minimum tax, changes to the minimum tax exemption period for interest on loans at preferential rates and the treatment of independent personnel services.

Before the new protocol to the DTA can take effect, it must be brought into force by the appropriate authorities in both countries. In enacting the protocol, it will be important to ensure that the application of withholding tax rules for royalties coincides with the commencement date.

The consultation process for the amending protocol to the DTA with the UK dated December 8, 1977, was completed on September 8, 2006. This protocol makes changes to the taxation of dividends, interest payments and royalties, the resolution of cases involving legal entities based in two different countries and mutual assistance rules. A memorandum of understanding on withholding tax relief for investment funds was also drawn up. The amending protocol provides that no residual withholding tax is payable on dividends, provided that the beneficiary company holds an equity interest of at least 10% either directly or indirectly in the company paying out the dividend. Dividend payments to pension schemes are also tax-exempt. In all other cases, withholding tax of 5% is payable, and may not be reclaimed. As is the case with the Spanish DTA, the mutual assistance clause has not been extended pursuant to agreements made to EU member states. ■

Changes to Canton Aargau and Canton Zurich Tax Law

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Changes to Aargau Tax Law

The first major change to Aargau tax law which has been in place since 2001 has four aims:

- To strengthen Canton Aargau's appeal as a place to live and do business
- To help the less well-off among the pensioners and working taxpayers
- To implement new compulsory federal legislation
- Various adjustments and simplifications

More than 50 legal provisions have been amended in total. The changes will enter into force in three stages between 2007 and 2010, provided voters approve the proposal on 26 November 2006.

Changes to Zurich Tax Law

Canton Zurich plans to implement the new compulsory federal legislation in 2008. It is currently unclear whether additional changes (mitigation of double taxation, other reliefs) will be made at the same time. ■

Action	Entry into force
Introduction of a staggered max. CHF 12,000 deduction for low-earners and people on low pensions. Applicable for net incomes of up to CHF 34,999.	2007
Deductions for children increased to CHF 6400 (up to 14 years old), CHF 8000 (up to 18) and CHF 9500 (adult but in education).	2007
Reduction in capital tax. Capital tax to fall from 2.5% to 1.25%. Corporation tax can now be set off against capital tax, meaning that businesses whose corporation tax (i.e. tax on profits) is higher than their capital tax effectively pay no capital tax.	2007
To mitigate the burden of double taxation, the tax value of shares and participation certificates of Swiss limited companies and cooperative societies that are not listed and not traded on any other organized market is being reduced by 50% (tax value currently 60%).	2007
The federal parliament's resolution on indirect partial liquidation and transposition is being incorporated into the new tax law.	2007
Income from investments in limited companies will be taxed at only 40% if the taxpayer holds a capital stake of at least 10% (mitigating the impact of effective double taxation).	2007
Amendments to comply with compulsory federal legislation: <ul style="list-style-type: none"> – Mergers law – Law against discrimination against people with disabilities – Partnership law – Foundation law – Federal law against illegal employment – Guarantee of judicial process 	2007
From 2009, limited companies will have to pay a simple tax of 6% on the first CHF 150,000 of taxable profit and 9% on the remaining net profit.	2009
The rate of wealth tax is being reduced by a standard 0.03%.	2010

Changes to Canton Berne and Canton Valais Tax Law

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Changes in Tax Law of the Canton of Berne

The Cantonal Council of the Canton of Berne adopted the partial revision of the tax law of the Canton of Berne for the consulting commission of the parliament. The parliament will debate on this partial revision in the first lecture in January 2007. The changes should become effective equated in the beginning of 2008 and 2010.

Stepwise tax relieves are planned for families and the middle class. As of January 1, 2008, the income tax rate shall be reduced for taxable incomes from CHF 30,000 and the lump sum deduction for children shall be increased in a first step. In a second step – as of January 2010 – the lump sum deduction for children shall be further increased and additionally the maximum tax rate shall be reduced.

Already as of January 1, 2008, the economic double taxation of companies and entrepreneurs shall be reduced in the context of the corporate tax reform. Precisely, a reduced income and wealth tax rate (method of partial taxation) shall be applicable under certain circumstances. Additionally, the wealth tax rate for individuals shall be reduced and in return the maximum tax burden rule shall be abolished.

Finally a tax relieve for company succession and a reduction of the withholding tax rate for artists, athletes and speakers are planned.

Changes in Tax Law of the Canton of Valais

After major changes which became effective on January 1, 2006, no revisions are planned for 2007. At the earliest per 2008 changes can be expected in the range of applicable tax rates for illegal work, new estimation of real estate and the guaranty of legal process. The implementation of the method of partial taxation is not to be expected within the near future.

Retroactively, as of January 1, 2005, the tax administration of the Canton of Valais was instructed to accept deductions on interest on building loans for cantonal and communal taxes. In cases which are already assessed definitively, the assessment 2005 will be revised. Likewise contributions to family allowance deposits (0.3% at the expense of the employee) are retroactively deductible. ■

Changes to Canton St. Gallen and Canton Appenzell Ausserrhoden Tax Law

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Canton St. Gallen: Tax Law Revision

Canton St. Gallen is revising its tax law with effect from January 1, 2007. The main items being amended are as follows:

- Introduction of the half-rate procedure for income from investment stakes of at least 10%, lower tariffs for low incomes and lumpsum payments, increased child and childcare deductions.
- Reduction in wealth tax rate from 2‰ to 1.9‰
- Progressive tariff (4.5%/7.5%) to be replaced by a proportional tax on profits of 4.5%.
- Capital tax will be reduced from 0.05‰ to 0.01‰ for holding and domiciliary companies and from 0.3‰ to 0.2‰ for other legal entities. The new law will reduce the effective corporate tax rate in Canton St. Gallen to below 20%. The half-rate procedure will mitigate the burden of double taxation on businesses. This will significantly improve Canton St. Gallen's standing compared with other cantons.

Canton Appenzell Ausserrhoden: Federal Supreme Court decision

The law on the use of extraordinary National Bank profits, which was approved by the electorate on May 21, 2006, has been challenged on the grounds of infringement of the unity of matter (Art. 34 para. 2 of the Federal Constitution). The appellant claimed that the revision of the tax law was yoked together with other provisions relating to the use of the one-off distribution of funds, but that this link was based merely on a political calculation by the Cantonal Council rather than any real connection between the two matters. The Federal Supreme Court has allowed the appeal and suspended the referendum. On January 1, 2008, a new draft of the revised tax law – this time without a degressive tax rate – is to be submitted to the vote. ■

Changes to Canton Vaud, Canton Geneva and Canton Neuchâtel Tax Law

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Changes to tax practices in the Canton of Vaud

In the 2007 tax year, the following modifications will be made to the tax system of the Canton of Vaud.

- 1) Tax installments will be remitted on a monthly basis. Therefore, in the month of November 2006, taxpayers will receive twelve payment forms for the full year of 2007. Penalty interest of 3.5% will be applied to all installments outstanding at the end of the month in which they are due.
- 2) The Vaud Cantonal Council will rule on a new Article 23a Vaud Tax Act in order to limit the concept of partial indirect liquidation on the sale of holdings in the capital of cooperative joint stock companies representing a transfer of private wealth to commercial wealth. As under the Swiss Federal tax regime, it will henceforth be necessary, in order to impose the tax, that *the funds which are not necessary for existing operations and which are available for distribution* within the meaning of commercial law at the time of sale, be distributed within five years with the vendor's holdings.
- 3) The Vaud Cantonal Council will also rule on a reduction of the tax rate on capital for mixed companies with international activities from 0.075% to 0.001%.
- 4) The relaxation of the concept of expatriates will allow expatriates with local contracts to fall within the scope of application of the OExpa (Expatriates Ordinance).
- 5) Deferral of tax on capital gains realized through the transfer of a real estate business asset to a private property asset: in the event of termination of an independent activity, an unsold property may be held as a "business asset" until its sale, transfer or disposal.
- 6) The relaxation of the concept of reinvestment will allow the posting of the undisclosed reserves of an operating asset that has been replaced or sold to another operating asset of a different kind.
- 7) The prohibition of double taxation on insurance benefits paid in the event of death. Henceforth the Canton of Vaud will tax as income all insurance benefits paid in the event of death and will exempt these benefits from inheritance tax. Thus, 2nd pillar and 3rd pillar a and b benefits will no longer be subject to inheritance tax. However, 3rd pillar b benefits in the form of pure risk insurance will henceforth be subject to income tax, whereas 40% of those benefits in the form of life annuity products will be subject to income tax and 60% to inheritance tax.

Changes to tax practices in the Canton of Geneva

As of 2007, tax deductions for representation costs incurred by employees who have a duty of representation may be applied at a flat rate in accordance with the following limits:

- 5% of the total gross salary, if the gross salary does not exceed CHF 250,000.
- 10% of the gross salary exceeding CHF 250,000.
- Capping of the annual deduction at CHF 100,000.

Tax practices in the Canton of Neuchâtel

Adaptation, as of January 1, 2007, of the law on inheritance and donations in accordance with the law on registered partnerships, and tax recognition of unmarried couples in individual tax declarations. Non-renewal of the "Law obliging Neuchâtel taxpayers with substantial wealth to make an exceptional contribution in the context of rebalancing the 2006 cantonal budget". As of 2008, adaptation of cantonal laws to be in line with the Law on Mergers. ■

Recent Tax Developments in Central Switzerland

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Canton of Lucerne

The amended Tax Act came into force in the Canton of Lucerne on January 1, 2005. In addition, the following changes have now been proposed:

Reduction of cantonal tax base

The Great Council of the Canton of Lucerne resolved to use the whole of the special distribution of Swiss National Bank gold due to the canton to pay off its debt. The resulting reduction in loan interest payments and write-offs have enabled the Canton of Lucerne to reduce the cantonal tax base from 1.7 to 1.6 on January 1, 2006.

Tax Act amendment in 2008

The Canton of Lucerne has proposed a further amendment to the Tax Act in 2008. On September 11, 2006, the Great Council of the Canton of Lucerne resolved to make the following amendments to the Tax Act, which are due to come into force on January 1, 2008: the retroactive wealth tax (a tax that is particular to the Canton of Lucerne) will be abolished without replacement; the burden on middle incomes will be reduced by adjusting tax rates; the effects of "cold progression" will be compensated; and additional income and wealth tax relief will be provided.

A tax cut for income tax on corporate profits has been proposed for January 1, 2010, reducing the rate from 4 to 3%. This would potentially place the Canton of Lucerne among the top five most attractive cantons once again. A capital tax cut has also been proposed from January 1, 2010. The 2005 amendment to the Tax Act only had the effect of lowering the rate for

taxable capital exceeding CHF 5 million. From now on, the lower rate will also apply to taxable capital below CHF 5 million.

New procedures for assessing single-parent families in cohabitation

In the case of cohabiting parents or individuals living with dependants, the taxpayer will be accorded the family rate irrespective of whether or not other people live in the same household. The directions set forth in relation to sections 41 no. 3 and 57 no. 1 of the Tax Act in the Lucerne Tax Register will be amended accordingly.

This amendment was prompted by a landmark decision made by the Federal Supreme Court on October 26, 2005.

Canton of Nidwalden

Amendment to the Nidwalden Tax Act

Following sweeping amendments to the Canton of Nidwalden Tax Act, which came into force on January 1, 2001, and the far-reaching changes that this entailed, the Canton of Nidwalden initiated a further partial amendment to the Tax Act in 2005. A referendum against the partial amendment was started. The only change from the Cantonal Council bill proposed by opponents to the partial amendment, was to keep real estate gains tax rates the same. Nidwalden voters approved the partial amendment to the Tax Act on May 21, 2006.

Capital tax cut

Basic capital tax on limited companies, cooperatives, holding companies, management companies, associations and foundations will be reduced from 0.035%

to 0.025% of taxable equity capital, subject to a minimum basic tax of CHF 500. A maximum tax charge of CHF 10,000 will be introduced for management companies.

Real estate gains tax

The maximum and minimum rates applying to real estate gains tax will be reduced depending on the period of home ownership. The minimum rate will be reduced to 12% (ownership of 30 years or more) and the maximum rate to 36% (ownership of 1 year or less). This is the equivalent on average to a reduction of 10%.

New Swiss Merger Act

A partial amendment has been made to the cantonal Tax Act, which implements the guidelines set out in the *Bundesgesetz über Fusion, Spaltung, Umwandlung und Vermögensübertragung* (Swiss Federal Merger Act) of October 3, 2003.

Other changes

- The divisor for calculating the tax rate applying to spouses who are taxable on a combined basis has now increased to 1.85 from 1.8 (partial splitting divisor).
- In addition, rate relief has been extended to the middle-income bracket and various tax breaks granted in relation to social security contributions.

The partial amendment is due to come into force on January 1, 2007.

Outlook

The Canton of Nidwalden is in the process of drafting further amendments on the back of Corporate Tax Reform II, which is

currently under review, and the Swiss Partnership Act. According to sources within the administrative structure, further tax relief (e.g. as applied to the half-rate procedure) is under consideration. However, the timing and implementation of this partial revision has not yet been determined.

Canton of Obwalden

Obwalden voters approved a partial amendment to the tax law on December 12, 2005. The amendment to the law extends substantial tax relief both to individuals and legal entities. The amendment came into force on January 1, 2006, and provides, among other things, for a cut in the corporate income tax rate to 6.6%, making it the lowest rate in Switzerland. An appeal against the sliding-scale tax rate for individuals has been lodged with the Federal Supreme Court under constitutional law. A decision is still pending.

Canton of Zug

The Zug Tax Act is to be amended in separate phases, involving two packages of reforms. The Zug electorate voted in favor of the first package of amendments on November 26, 2006. The initial amendments introduce the following changes:

Capital tax for holding companies

Capital tax for holding companies will be reduced from 0.0075% at current levels to 0.002% of taxable equity capital, while the basic minimum capital tax for holding companies will be raised from CHF 150 to CHF 250.

“Nidwalden model“

The double tax burden on distributed profits for limited companies and shareholders will be reduced along the lines of the “Nidwalden model”. Distributed profits

will only be taxed at 70% (tax rate and calculation basis), provided that the company has unlimited tax liability in Switzerland and the unitholder holds a minimum 5% stake in the company, or the market value of the holding is CHF 5 million or more. The wealth tax rate should also be reduced along similar lines. Table 1 provides an overview of tax relief measures previously implemented or in prospect in Central Switzerland.

Other changes

- The Canton of Zug Tax Act is to be amended to bring it in line with the Swiss Merger Act of October 3, 2003.
- The partial amendment to the Tax Act will also introduce further relief for individuals. The bill provides inter alia for an increase in deductions for children, childcare and the net income threshold for rental deductions.

The first package of amendments is due to come into force on January 1, 2007. The second package is expected to take effect on January 1, 2008.

Details of the second package of amendments are not yet known. What is certain is that the second package will deal with the new federal subsidization system and its implementation.

Canton of Schwyz

On February 12, 2006, Schwyz voters came out in favor of a partial amendment to the tax law. The amended law will come into force on January 1, 2007. The key amendments are as follows:

“Nidwalden model“

The amendment reduces the double tax burden on business profits. Dividends paid to taxpayers who hold a stake of 5% or more in the company making the distri-

bution will only be taxed at a quarter of the rate applying to their total taxable income.

Wealth tax cut

Wealth tax will be cut from 0.08% to 0.05%.

Capital tax reduction for companies

The capital tax rate for companies, which are taxed at the normal rate, will be halved from 0.08% of taxable capital to 0.04%.

For holding, domiciliary and mixed companies, the capital tax rate has been cut from 0.005% to 0.0025%, subject to a minimum tax of CHF 100.

Other changes

- The guidelines laid down in the *Bundesgesetz über Fusion, Spaltung, Umwandlung und Vermögensübertragung* (Swiss Merger Act) of October 3, 2003, have been implemented.
- The tax-deductible allowance for donations to tax-exempt, legal entities engaging in charitable activities in Switzerland and sovereign territories has now been increased from 10% to 20% of net income.
- The amendment to the law also provides for an increase in deductions for children, the introduction of 12-month tax returns and the abolition of tax certificates.

Canton of Uri

The Uri electorate voted in favor of a partial amendment to the tax law on November 26, 2006. This is due to come into force on January 1, 2007.

Capital tax cut

Municipalities within the Canton of Uri now have the option to set optimum capital tax rates to suit their particular eco-

conomic and social structures. This optimum tax rate can be set within a range of 0.001 to 0.24%.

The capital tax rate for affiliated and holding companies has been reduced from 0.005 to 0.001%.

Corporate income tax reduction

The amendment now provides for a corporate income tax rate of 11% pro rata. Under the current law, the maximum rate is 22%.

“Nidwalden model“

The double tax burden on business profits has now been reduced. Dividends and shares held by taxpayers holding a stake of more than 10% in a limited company are now taxable at 40%.

Other changes

The amendment to the tax law includes a raft of additional relief measures. These include:

- Child and childcare deductions have been reduced substantially.
- Wealth tax has been reduced as part of the general revaluation of property.
- Increase in deductions for donations.

New Swiss Merger Act

The new Swiss Merger Act has been amended to extend the tax privileges available for business restructuring to new forms of restructuring. ■

	Nidwalden	Obwalden	Lucerne	Zug	Schwyz
Introduction	1.1.2001	1.1.2001	1.1.2005	1.1.2007	1.1.2007
Conditions	5% or market value of CHF 5 million	20% stake	5% or market value of CHF 5 million	5% or market value of CHF 5 million	5% stake
Dividend relief	Half the rate applying to total taxable income	Half the rate applying to total taxable income	Half the rate applying to total taxable income	30% relief	75% relief
Wealth tax relief	Reduced rate 0.020% (instead of 0.035%)	No relief	40% relief	30% relief	No relief

Table 1

VAT Practice Note Dated October 31, 2006

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The *Verordnung zum Bundesgesetz über die Mehrwertsteuer* (MWSTGV) (Swiss Value Added Tax Act Implementing Ordinance) was amended on July 1, 2006. The main amendment concerns *Art. 45a of the MWSTGV*. This provides that the Swiss Federal Tax Administration (FTA) may not impose additional tax charges merely on the grounds of formal defects, if it is clear in the circumstances or the taxpayer is able to prove that no tax shortfall to the federal government has occurred due to his failure to comply with some formal requirement when submitting supporting documents. On October 31, 2006, the FTA's Main VAT Division issued a practice note, which attempts to address the practical implications of this new provision of the ordinance.

Focus on Substantive Assessment

In the introduction to its practice note, the FTA states that *Art. 45a MWSTGV* should be construed as a blanket provision, the purpose of which is to ensure that the actual circumstances of a given case are assessed pragmatically rather than in an overly formalistic way. *Art. 45a* focuses on substantive tax assessment, i.e. establishing the actual facts and circumstances and assessing these with reference to applicable rules. The assessment should be conducted pragmatically based on careful consideration of all the relevant documents.

It is also possible for taxpayers simply to submit evidence showing that the federal government has not incurred any tax shortfall in the circumstances. In clear-cut cases, the FTA may waive the requirement to produce evidence.

Application

The new provisions apply to all future cases and any contested cases still pending as at July 1, 2006.

MWSTG Remains in Force

Art. 45a does not have the effect of repealing any existing provisions of the *Bundesgesetz über die Mehrwertsteuer* (MWSTG) (Swiss Value Added Tax Act). The MWSTG will of course continue to govern all dealings between taxpayers and the FTA until the amended statute comes into force. The new provisions and the new spirit at the FTA mean that any future noncompliance with formal requirements by taxpayers will not necessarily result in a subsequent tax adjustment.

Examples

The FTA has provided a series of examples, which it explicitly claims are not exhaustive, showing how it intends to approach tax audits in future. The three examples provided below are intended to clarify and further define the FTA's approach.

Formal Entitlement to Retroactive Input Tax Relief

Art. 15a MWSTGV and related statements in the practice note confirm the continuing shift towards pragmatism, which has been evident for some time now. Until recently, defects involving VAT numbers, invoice periods, tax rates and descriptions of goods/services could all give rise to tax adjustments. If an incorrect name was used, i.e. a name other than the approved business name for the contracting parties, this could not be corrected

subsequently, which often resulted in the taxpayer being denied input tax relief. This practice should now be discontinued, provided that the parties are clearly identifiable from the information set out in the invoice. The costs incurred or work performed must also be justified on commercial grounds, must generate taxable turnover and be recorded in the recipient's accounts, or in accordance with applicable rules.

The rules have also been eased in assessing eligibility for retroactive input tax relief in relation to investments that are in the set-up phase (*Art. 42 MWSTG*). It is now possible to claim retroactive input tax relief even if invoices are not issued in the name of the company during the set-up phase – a common practice which cannot always be avoided.

The FTA has also relaxed its highly contentious stance that VAT declared on purchases of services may only be claimed as input tax if an invoice satisfying the requirements of *Art. 37 MWSTG* in all material respects is issued. It is now possible to claim input tax even if the description of the goods/services is inadequate, provided that a taxable use can be established. Taxpayers who are eligible for full input tax relief will generally be deemed to have met this evidentiary requirement.

Evidence of Tax Exemption

Where goods are exported outside Switzerland, evidence of tax exemption must generally be provided by producing an appropriate customs-stamped certificate. However, tax-exempt status will now be conferred even if in some cases the wrong export certificate has been used, or

the import documents can be produced. As a result, services pursuant to Art. 14 (3) MWSTG will not now be subject to Swiss VAT if they were supplied to recipients abroad and it can be shown in the totality of the circumstances that the services supplied satisfy the requirements of Art. 14 (3) MWSTG.

Tolerance Rules

If, by mistake, no invoice has been submitted for intra-group services, the FTA will waive any back taxes on past services supplied (but not tax on future supplies of services), provided that the recipient of the services is eligible for full input tax relief. The same applies to taxable countertransactions between parties who are eligible for full input tax relief.

It was not previously possible to claim input tax relief on services on which no VAT was charged, where the services were supplied by a company that did not qualify for mandatory VAT but subsequently made a VAT election. It is now possible for companies to charge tax on supplies of services and claim input tax relief retrospectively when filing their first VAT declaration after the VAT election is made. Since no time restrictions have been imposed, we assume that this procedure will apply automatically.

Conclusion

The FTA is shifting away from the application of strict formal requirements in favor of substantive assessments. This is a very welcome development. The combined effect of the MWSTG, MWSTGV and FTA administrative guidelines amount to a set of safe haven rules for taxpayers: provided that the requirements are met, tax audits will most likely result in minimal or no subsequent tax adjustments. This of course is based on the premise that the facts of the case are prop-

erly assessed on substantive grounds. Even if the taxpayer has omitted to comply fully with the formal requirements, it is still possible to show that VAT procedures were duly followed in the totality of the circumstances, or on the basis of prima facie evidence. ■

Tax Amnesty

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Draft law on Additional Taxation in Inheritance Cases and the Introduction of Voluntary Declaration with Immunity from Prosecution.

On October 18, 2006 the Federal Council published its Message on the Federal Law on Simplification of Additional Taxation in Inheritance Cases and the Introduction of Voluntary Declaration with Immunity from Prosecution, along with the accompanying draft law. Both measures apply to federal direct tax as well as cantonal and municipal income and wealth tax. Any other overdue taxes and duties, including VAT, withholding tax, inheritance and gift tax or AHV/IV contributions, must still be paid along with all interest due.

Additional Taxation in Inheritance Cases

The current draft law is intended to simplify the additional taxation of heirs. The basic period for the additional taxation process should be reduced from the current ten years to the last three tax periods prior to the year of death. Additional tax

and interest on arrears should, as now, be calculated exactly.

The Introduction of Voluntary Declaration with Immunity from Prosecution

The draft law also seeks to introduce an individual amnesty for individuals and legal entities. Currently, a person who voluntarily declares tax evasion is punished with a fine of up to one-fifth of the tax evaded. Taxpayers will in future no longer have to pay this fine on the first voluntary declaration. However, they must pay the normal subsequent tax (for up to ten years), plus interest on arrears. People who assist tax evasion can in future also declare their actions and be exempted from the fine and from joint liability for the tax evaded.

Voluntary declaration with immunity from prosecution must, however, be of a one-off nature. For any further declarations, a fine of one-fifth of the tax evaded will, as now, be imposed in addition to the additional tax and interest on arrears. ■

Indirect Partial Liquidation: Legislation and Draft Circular

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Art. 16 (3) of the Swiss Federal Direct Tax Act (*Bundesgesetz über die direkte Bundessteuer*; DBG) provides that if an individual realizes a capital gain on the sale of private assets, e.g. shares, such capital gain is tax-exempt.

The Federal Tax Administration (FTA) assessment practice has significantly restricted this basic principle on a number of fronts, e.g. in connection with the so-called quasi securities dealers, the transposition theory and the indirect partial liquidation practice.

Over the last few years, in particular the FTA's position on indirect partial liquidation has hardened substantially. The Federal Supreme Court has given its full backing to the FTA's increasingly erratic assessment practice to the detriment of taxpayers. These recent developments have prompted urgent amendments to the legislation with a view to regularizing interpretation of Art. 16 (3) DBG.

Development of Practice on Indirect Partial Liquidation

Past practice relating to indirect partial liquidation can be summarized as follows: if a shareholder takes assets from the company (e.g. dividends), income tax is payable on the profits earned. If, however, no dividends are paid out and the company is sold at a later date, the shareholder collects the purchase price (augmented by any reserves remaining in the company), basically as a tax-free capital gain. The higher price does basically not have a neg-

ative effect for a purchaser holding the acquired participation as business assets: The purchaser can finance the higher price paid by drawing reserves from the target company immediately after acquisition. This distribution will be largely tax-free if the dividend income is offset against amortization of the participation, or if the participation reduction regime (*Beteiligungszug*) is claimed.

Pursuant to FTA and Federal Supreme Court practice, the capital gain realized by the seller is deemed to be converted into taxable investment income to the extent the purchaser finances the purchase by using funds extracted from the acquired company. Having tightened up this practice over a period of time, the FTA recently argued that the use of assets available in the target company at the time of sale is not the only factor likely to be prejudicial. Indirect partial liquidation has also been deemed to arise where post-acquisition gains were realized and used to finance acquisition-related debt. Having defined this practice in a draft Circular (no. 7, dated February 14, 2005), the FTA has proceeded to enforce this, even though the final version of the Circular never came into effect. Given that most company purchases are largely or partly financed with borrowed funds, practically every company sale by a private shareholder has subsequently been categorized as indirect partial liquidation.

The very narrow interpretation of Art. 16 (3) DBG in draft Circular no. 7 thwart-

ed the original legislative intent. The Swiss parliament intended to define the legal requirements for indirect partial liquidation as part of Corporate Tax Reform II. Given the politically sensitive nature of many of the issues to be tackled under Corporate Tax Reform II, this reform is unlikely to be implemented any time soon. Because of the urgency surrounding the partial liquidation theory – not least due to the plethora of pending and upcoming succession plans in Switzerland –, indirect partial liquidation (and the transposition theory, which is not dealt with here) has now been taken out of Corporate Tax Reform II and addressed specifically in (the *Bundesgesetz über dringende Anpassungen bei der Unternehmensbesteuerung vom 23. Juni 2006*) Federal Law on Urgent Amendments In Corporate Taxation of June 23, 2006, enters into force on January 1, 2007.

New Legal Provisions on Indirect Partial Liquidation

The new Art. 20a (1) DBG provides that indirect partial liquidation is deemed to exist if all of the following conditions are met:

- Sale of shares held as private asset by seller to a purchaser holding the shares as business asset.

A transfer from private assets to business assets has always been required for the indirect partial liquidation theory to be applied. Only if the buyer holds the interest as business assets is it possible

for him to distribute the funds, which are used to finance the purchase price, in a tax neutral way, either by amortizing the interest and reducing his tax liability, or by applying the participation reduction on dividends (Beteiligungsabzug).

- The seller sells shares representing at least 20% of the nominal capital of a company or cooperative.

The 20% minimum quota was introduced with the new statutory provisions. This quota will also be met if several parties jointly sell such an interest, or sell interests which together total 20% or more of the capital.

- Distribution of nonoperational substance of the acquired company, which at the time of sale was available and freely distributable under commercial law, within five years of sale.

The law explicitly states that the time of sale is decisive in that indirect partial liquidation will only be deemed to exist to the extent that nonoperational assets were available on the applicable date. These assets must also be distributable under commercial law. Any future profits realized, i.e. post-sale, may thus be distributed without tax implications for the seller.

- Cooperation between seller and purchaser with regard to the financing of the purchase price out of the target company's funds. According to Art. 20a (2) DBG such cooperation will be assumed if the seller knows or ought to have known that funds would be permanently removed from the company to finance the purchase price.

The seller's cooperation was previously a requirement for indirect partial liquidation. The legislation still provides that

both active and, in certain circumstances, passive cooperation may prove harmful.

Proposed FTA interpretation of the new statutory provisions

On November 17, 2006, the FTA published another draft Circular in an attempt to provide some clarity as to the interpretation of Art. 20a (1) and (2) DBG (draft Circular no. 14, *Verkauf von Beteiligungsrechten aus dem Privat- in das Geschäftsvermögen eines Dritten* [concerning sales involving a transfer of privately held ownership interests to the business assets of a third party]). The FTA Circular ignores the clear objective of the legislation which is to limit the scope of indirect partial liquidation. This is indicated by the FTA's approach to the following:

Cooperation

The FTA interprets the 20% minimum quota extremely widely. The FTA interpretation of the joint sale requirement and the type of sales that would be prejudicial extends to sales that are merely simultaneous (where "simultaneous" in this context means "within five years") and the sellers do not act with joint volition. In other words, the FTA proceeds on the assumption that even though the legislation prescribes a joint sale, a joint sale is an objective fact and does not require any coordination or cooperation on the part of the sellers. According to this logic, the FTA would even regard a public takeover bid as satisfying the requirements of a joint sale. Based on the FTA's reading of Art. 20a (1) DBG, a sale of 18% by a shareholder followed by an additional sale of 2% by other shareholders within five years of the sale is considered harmful, even if these shares were sold on the stock exchange.

The FTA also makes some extremely sweeping presumptions about the seller's cooperation with purchaser stripping assets from the company, and, disregarding the new legal provision, making undue reference to the assessment practice applied by the FTA and the federal court prior to implementation of the new Art. 20a (1) DBG.

Sales

According to the new draft Circular, the new legal provision not only covers straight forward sales transactions, but also barter transactions. If this were the case, even share transfers made in the course of (tax-neutral) restructurings could qualify as indirect partial liquidation and thus have tax implications.

Distributions

According to the FTA, harmful distributions would not only include ordinary, extraordinary and hidden profit distributions, but also loans granted to the buyer by the sold entity, even if there is no evidence to assume that the loan would not be repaid. Furthermore, by applying the hitherto existing indirect partial liquidation practice, collaterals provided by the sold entity as security for acquisition-related loans are also regarded as harmful, even if it appears unlikely that the collateral would be drawn on, and no provision is required in the company's books due to the collateral.

Nonoperational substance

The FTA takes the assumption that the commercially distributable reserves of the target company equal the nonoperational liquid assets. Besides the question how far off reality this assumption is, it repre-

sents in our view an undue shift in the burden of proof from the tax authorities to the taxpayer: On the basis of Art. 16 (3) DBG, the taxpayer may basically assume that any capital gain realized on sales of privately held assets is, as a general rule, tax-exempt. It is consequently the FTA's burden to prove that a capital gain should be taxed. Nevertheless, the FTA intends to shift this burden of proof to the taxpayer.

Conclusion

If Art. 20a (1) were to be interpreted as suggested in the draft Circular, this would strip the legal provisions of their essential meaning and disregard the intention of the legislator, which was clearly expressed during parliamentary consultations.

Ernst & Young, together with other representatives from business and politics, has responded to the draft Circular, taking specific issue with the matters referred to above. We trust this will help give effect to the act's legislative intent, i.e. by forcing the FTA to make relevant amendments to Circular no. 14. Otherwise the new Art. 20a (1) DBG would have to undergo yet another formal process of legal amendment immediately after it has entered into force. ■

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