

# Tax News

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Dear Reader

After protracted negotiations with the business community and the cantons, the Swiss Federal Tax Administration has published the final version of Circular 14 on the transfer of privately held shares to the business assets of a third party (indirect partial liquidation).

Varying practices in dealing with such cases of indirect partial liquidation have often led to difficulty in interpreting regulations and legal uncertainty in the past. The call for legislation was prompted by the widely publicized and justifiably criticized decision of the Federal Supreme Court of June 11, 2004 ([Erbengold] Decision on holdings and successions) which massively extended the application of the term indirect partial liquidation. The regulations on indirect partial liquidation and transfer of assets were taken out of Corporation Tax Reform II and dealt with separately in the Swiss Corporate Taxation Urgent Amendments Act of June 23, 2006. Amended Art. 20a of the *Bundesgesetz über die direkte Bundessteuer* (Swiss Direct Federal Tax Act [DBG]) has been in force since January 1, 2007, and in the meantime after having completed an exhaustive path through consultation, which began with the first draft back in November 2006, the final version of Circular 14 has been published.

The stipulations of Art. 20a (DBG) and Circular 14 will have a significant effect on the economy because they are directly concerned with the sale of firms. If in specific circumstances it is deemed that an indirect partial liquidation has taken

place, this will involve major tax consequences for the seller because the proceeds will not be classified as a tax-free capital gain but rather as taxable income derived from movable assets. While the former decision of the Tribunal in June 2004 made succession planning for privately owned corporations much more difficult, the amended regulations create a substantially improved tax environment for the sale of companies and establish clear principles. Although Circular 14 does not answer all questions, the degree of detail it contains contributes significantly to reestablishing legal certainty.

See the article on page 7 for further details.

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## US Tax Desk: Proposed Legislation to Deny Treaty Benefits on Deductible Payments to Certain Foreign Related Parties

**Recently legislation has been reintroduced into the US House of Representatives («House») to discourage use of foreign related parties in certain situations to receive US deductible payments by denying US treaty benefits where the recipient is not the ultimate foreign parent company. This legislation had been previously introduced into the House in the spring of 2007.**

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Specifically, under this legislation US domestic tax law would be amended to provide that in the case of any deductible related party payment, the treaty withholding tax rate shall be no less than the rate provided for under the relevant US treaty with the country of the ultimate foreign parent corporation. Effectively, entities will be considered to be related parties for purposes of this rule if ultimately controlled by the same foreign parent corporation. Here «control» means more than 50% of the vote power or value of the shares of the related party corporation.

Such legislation could significantly impact countries typically used for financing operations by multinational corporations, such as Switzerland. One obvious target of the legislation are low-taxed intermediary entities used by multinational companies «to avoid taxes on income earned in the US», as indicated by the congressman sponsoring the proposed legislation. The proposed legislation is controversial because it will override in-force treaties and likely will antagonize existing treaty country trading partners of the US.

The Bush White House, as well as many Republican senators (both houses of Congress are currently controlled by the Democrats), have indicated that they oppose this legislation and the White House has stated that it will veto any legislation containing this provision. Given that the legislation is viewed as a revenue raiser, and that the House leadership supports it (although the Democrat-controlled Senate leadership has

indicated that it does not), the progress of this legislation should be carefully monitored by multinationals potentially affected by this new legislation.

### US Treaty developments

The US Senate Foreign Relations Committee held hearings this summer to consider the following protocols and treaty:

- US – Germany Protocol
- US – Finland Protocol
- US – Denmark Protocol
- US – Belgium Income Tax Treaty and Protocol («Tax Treaty»)

Furthermore, the US Treasury Department and Congressional Joint Committee on Taxation released official explanations of the protocols and treaty. Of interest to Switzerland, as noted before, is that all of the above treaties and protocols provide for the elimination of dividend withholding tax on dividends from 80% owned subsidiaries (versus the typical US treaty which provides for 5% in the case of 10% owned subsidiaries, such as the Swiss-US treaty). Further, the German protocol and the Belgian treaty provide for mandatory binding arbitration in certain cases where the two countries' competent authorities are unable to reach agreement. The current Swiss-US treaty provides for an optional binding arbitration system, part of which is not yet operational. ■

## Double Taxation Treaties (DTT): Latest Developments

**A number of double taxation treaties have recently been completed or ratified. The following article provides an overview of the most important changes and updates made to double taxation treaties concluded between Switzerland and the following countries: Azerbaijan, the UK/Northern Ireland, Serbia/Montenegro and South Africa.**

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### Azerbaijan

On February 23, 2006, Switzerland and Azerbaijan ratified a treaty for the avoidance of the double taxation of income and assets.

The rate of withholding tax imposed on dividends resulting from qualifying participations is limited to 5%. An investment in a subsidiary is deemed to be a qualifying participation if the dividend-receiving company owns at least 20% of the shares in the company paying the dividends. A peculiarity of this double taxation treaty is the requirement that at least USD 200,000 must be invested in the country of source in order to qualify for the reduced withholding tax rate on dividend payments (otherwise a basic rate of maximum 15% of the gross dividend applies).

As far as interest payments are concerned, the agreement basically provides for a maximum withholding tax rate of 10% of the gross amount of interest paid. However, interest paid, for example, for the sale of industrial equipment on credit is, according to the wording of the agreement, fully excluded from withholding tax. Tax on other interest-bearing items such as bank loans is limited to a maximum of 5% of the gross amount.

Royalty payments on patents, samples, models and other specific types of intellectual property are taxed at a maximum basic rate of 5%. A maximum withholding tax rate of 10% is planned for all other royalties.

The agreement entered into force on July 13, 2007. Its provisions regarding the taxation of income and assets will take effect for the first time on or after January 1, 2008.

### UK/Northern Ireland

The current double taxation treaty (DTT) between Switzerland and the UK/Northern Ireland for the avoidance of the double taxation of income tax dates back to 1977.

In response to the changes in economic conditions, representatives of the UK and Switzerland met in London to sign a protocol to the DTT of December 8, 1977. The most significant amendment in the protocol is complete withholding tax relief on cross-border payments of dividends if the recipient of the dividends holds at least 10% of the capital of the company paying the dividend. A basic rate of 15% continues to apply to all other dividend payments. The signed protocol also contains changes in connection with the taxation of pension benefits. Dividend payments to pension fund facilities are exempt from withholding tax. Furthermore, lump-sum benefits may in future solely be taxed by the state in which they arise, whereas social insurance and pension fund contributions paid in a contracting country are, under certain circumstances, tax deductible in the other country. The amending protocol also broadens the exchange of information between the contracting countries. The protocol now contains provisions providing collaboration between administrative authorities in case of tax fraud or similar offences and with regard to holding companies. The amending protocol is still awaiting approval by the competent authorities of both contracting states, which is why it is not expected to enter into force before January 1, 2009. With regard to

dividend payments under the double taxation agreement a timely planning is particularly advisable at this stage.

### Serbia/Montenegro

On April 13, 2005, Switzerland signed a double taxation treaty with Serbia and Montenegro for the avoidance of the double taxation of income and assets. At the time of the conclusion of the agreement, Montenegro was still a part of Serbia. Approximately one year later, on May 21, 2006, the population of Montenegro voted in a referendum to secede from Serbia. The secession was granted to the country on June 3, 2006.

An exchange of notes dated June 29/July 10, 2007, between Switzerland and Montenegro takes the latter's secession from Serbia into account and regulates the applicability of the Swiss – Serbia/Montenegro DTT with respect to the now independent state of Montenegro. Due to the exchange of notes, the DTT, which was temporarily valid solely between Switzerland and Serbia, on account of Montenegro's secession, also now applies to Montenegro with retroactive effect to its date of independence.

The Swiss-Serbia/Montenegro DTT entered into force on May 5, 2006. Its provisions relating to Serbia as well as Montenegro regarding the taxation of income and assets take effect for the first time on or after January 1, 2007.

## South Africa

In Pretoria, on May 8, 2007, Switzerland and South Africa signed a revised version of their existing double taxation treaty for the avoidance of double taxation of income and assets. This DTT replaces the previous one of July 3, 1967, which is particularly outdated in terms of its formality and which has never been revised since. In addition, various provisions of the agreement were amended to reflect the political developments in the two contracting states.

The existing DTT subjects all dividend payments to a withholding tax rate not exceeding 7.5%. The rates under the revised DTT have been aligned with those in the OECD model convention, which limits the withholding tax rate on dividends from qualifying participations to 5%. The threshold for qualifying participations is 20% of the capital of the company paying out the dividends. In all other cases, a maximum basic tax rate of 15% applies.

As regards interest payments the general maximum basic rate was lowered from 10% to 5%, whereupon it must be noted that South Africa currently does not impose withholding tax on interest paid abroad. The revised DTT contains no changes to the tax treatment of royalties.

The agreement, however, now includes an arbitration tribunal clause to deal with any common disputes relating to issues of tax law. The arbitration tribunal is empowered to make binding decisions for the tax authorities as well as for the tax payers.

With a view to ensuring the proper application of the agreement, the existing treaty was amended to include a provision for the mutual exchange of information. The article on the exchange of information also regulates the collaboration between the administrative authorities in combating tax fraud.

The revised DTT is still awaiting approval and ratification by the competent authorities of both contracting countries, which is why it is not expected to enter into force before 2009. ■

## Taxation of Transfer of Functions in Germany

### First draft of the executive order contains further details

**The 2008 Business Tax Reform<sup>1</sup> contains significant transfer pricing changes, in particular concerning the transfer of functions.<sup>2</sup> The German Ministry of Finance has recently published a draft of the executive order detailing the new regulations on the transfer of functions.**

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Key to the new transfer pricing regulations are the provisions on the transfer of functions including retroactive transfer pricing adjustments. The German Federal Ministry of Finance has released more details hereon in the draft *Verordnung zur Anwendung des Fremdvergleichsgrundsatzes des § 1 Abs. 1 des Aussensteuergesetzes in Fällen grenzüberschreitender Funktionsverlagerungen (Funktionsverlagerungsverordnung – FVerlagV)*<sup>3</sup> (hereafter «RVO-E»). The executive order is binding for taxpayers, courts and the tax administration. In addition, the publication of – for the taxpayer not binding – administrative principles is planned. The new transfer pricing regulations as well as the executive order shall apply for the assessment period 2008 for the first time.<sup>4</sup>

### Definition of the term transfer of functions

According to the RVO-E, a transfer of functions will be assumed if a function is shifted between affiliated companies. A function is defined as the combination of similar operational tasks including the inherent opportunities and risks that are performed by specific business units or departments of a company. Business transactions of different years are to be pooled if under economic aspects they are to be regarded as parts of one transfer of function. Even a temporary or partial shifting may constitute a transfer of function. However, no transfer of function will be assumed just if business assets are disposed of or let or in instances where employees are assigned provided no func-

tions are shifted in this connection. In addition, the draft stipulates that the rules will apply accordingly if functions are duplicated, e.g. in cases where a company adopts a function from an affiliated company while utilizing the latter's assets and advantages, but without the latter reducing its hitherto business activities. If there are doubts as to whether a transfer has taken place or the usage of assets been granted, the latter is to be assumed. The beneficiary is then obliged to pay an appropriate arm's length compensation.

### Determining the appropriate arm's length compensation

Basis for determining the arm's length remuneration is the so-called transfer package. Like in the statute, the RVO-E defines the term rather broadly by including all opportunities and risks connected with the function as well as the assigned or let assets and advantages. A valuation on single-asset basis is only allowed where no intangible assets or goodwill are transferred (less than 5% of the total transfer package) and the sum of the transfer prices for the individually evaluated assets equal the value of the total transfer package at least. A transfer package will be assumed as not being shifted if the receiving company performs the functions for the transferring company only and an arm's length remuneration is determined by applying the cost plus method.

The total remuneration for the transfer package is to be determined within the settlement area as confined by the profit

potentials of the assigning company (minimum price) and the receiving company (maximum price) on the basis of a functional analysis before and after the transfer of functions.<sup>5</sup> According to the RVO-E, the calculation of the profit potentials should be based on the estimated net income after taxes taking into consideration appropriate capitalization rates<sup>6</sup> and an unlimited capitalization period. When determining the (maximum) price for the receiving company, explicitly all location advantages or disadvantages as well as synergy effects have to be taken into consideration. This may effectively result in their partial taxation in Germany, similar to when the resale price minus and the cost plus methods are applied in cases where the principal is domiciled there.

### Transfer pricing adjustments

Finally, the new codified regulations on the transfer of functions contain the rebuttable assumption that where substantial intangible assets are shifted (more than 5% of the total transfer package) third parties would have agreed on a price adjustment clause. Accordingly, the tax authorities are entitled to a one-time adjustment of the transfer price agreed in the event that the actual profits generated later differ substantially from the forecasts which were the basis for the original transfer price. The transfer pricing adjustment mandatorily has to be made in the year after the year in which the substantial deviation has occurred. According to the RVO-E, a substantial deviation is to be assumed if an evaluation on the basis of the actual profit developments shows that the transfer price now lies outside the original settlement area. The adjustment equals the difference between the original transfer price and the newly established price (average of the settlement area, provided the taxpayer has not been able to prove the reasonableness of another transfer price). If the maximum price of the newly calculated settlement area is lower than

the former minimum price, the transfer pricing adjustment is based on the former transfer price less the average of the old minimum price and the new maximum price.

### Perspective

The goal of the new transfer pricing regulations in the 2008 Business Tax Reform is to specify the at arm's length principle as described in the 1995 OECD Transfer Pricing Guidelines. Currently, an OECD working group is exploring the treaty and transfer pricing aspects of business restructurings including permanent establishment issues.<sup>7</sup> Therefore, developments on an international level remain to be seen, e.g. whether the OECD and other countries will follow the German approach. ■

<sup>1</sup> For details of the 2008 Business Tax Reform, see Kubaile in: Huber/Ziegler/Kubaile/Freimoser, «Entwicklungen im Internationalen Steuerrecht», *SteuerRevue* No. 6 2007, p. 393, and in: «Der Schweizer Treuhänder» No. 10 2007, p. 766-772.

<sup>2</sup> For a complete overview of the most significant transfer pricing changes, see Damji/Wolff, «2008 Business Tax Reform of Taxation of Businesses and Individuals - Transfer Pricing Impacts», *Der Schweizer Treuhänder* No. 9 2007, pp. 684/688.

<sup>3</sup> Executive order on the application of the arm's length principle in § 1 para. 1 of the Foreign Tax Act in cases of cross-border transfer of functions (Transfer of Functions Executive Order).

<sup>4</sup> For companies whose financial year does not correspond to the calendar year this means that the new transfer pricing regulations will apply for the financial year 2007/2008 for the first time.

<sup>5</sup> The legally rebuttable assumption applies according to which the average value of the settlement area is the appropriate at arm's length price.

<sup>6</sup> To determine an appropriate capitalization rate a risk-free investment should be assumed for which a function and a risk-adequate surcharge is to be made.

<sup>7</sup> See [www.oecd.org/topic/0,3373,en\\_2649\\_37989760\\_1\\_1\\_1\\_1\\_37427,00.html](http://www.oecd.org/topic/0,3373,en_2649_37989760_1_1_1_1_37427,00.html).

## Modification of a Previously Implemented Taxation Decision

**The Federal Court has recently returned a decision concerning the admissibility of a modification, made by the canton of location of a secondary residence, to a taxation decision that had already been implemented (ATF 2A.585/2005/ast).**

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The facts of the case concerned a couple living in the canton of Berne. The wife owned a holiday home in the canton of Fribourg. The canton had definitively assessed this property for tax purposes on February 20, 2003, without having received any tax return, simply basing its calculation on previous year's data. It then revised the tax liability upwards, following the definitive tax assessment made by the canton of Berne, which contained different income and wealth data.

The case in point raised the question of the possibility of a tax adjustment. In this respect, the Federal Court emphasized that a tax adjustment was only possible where evidence or facts that were hitherto unknown to the tax authority would allow it to establish that the tax had not been levied as it should have been. Thus, a lack of information on the part of the tax authority would not justify a tax adjustment if the authority was in a position to obtain such information, even if the taxpayers had not done everything necessary to ensure a full and accurate assessment by submitting a tax return in the canton of Fribourg or furnishing a copy of the tax return submitted to the canton of Berne. Indeed, and as recommended by the law, the tax authorities freely communicate all useful information between themselves and are authorized to consult each others' files. In this case, the canton of Fribourg taxed the couple without requesting information from the canton of Berne. Even if Berne had not determined its final tax assessment, Fribourg could have provisionally taxed the couple and awaited the data from Berne before notifying them of

its definitive assessment. Furthermore, neither the conditions regarding such revisions nor the conditions relating to transcription or calculation errors were met.

It results from this Federal Court ruling that the canton in which the secondary residence is located has the right to levy taxation prior to the canton of main residence, but it cannot thereafter revise it unless it has issued a clear reservation. Indeed, if it consciously omits to clarify the circumstances, it does not have the right to make an adjustment if it becomes aware of certain facts retrospectively.

On August 15, 2006, the Administrative Court of the canton of Berne pronounced judgement in a similar case. The tax authorities had corrected a decision that had been implemented. The Court noted in its recitals that such correction was only admissible in order to rectify calculation or transcription errors, and not those errors committed in reaching a conclusion (*Willensbildung*). In this case, the tax authority had omitted to take account of certain income in its assessment and had subsequently corrected this. However, this was an error of judgement on its part, not a miscalculation or a transcription error.

The courts ruled in favor of the taxpayers in both cases, although the taxpayers had not done everything necessary to ensure a full and accurate assessment. The certainty afforded by the law would therefore seem to prevail over the very restrictive conditions applicable to cases of abuse of the law. The decision of the Federal Court thus helps strengthen legal certainty. ■

## Indirect Partial Liquidation – Amendments to Circular 14

**Circular 14 (CS 14) dealing with the transfer of privately held shares to the business assets of a third party has now been finalized after long, drawn-out negotiations. The initial draft of CS 14, which is based on amended Art. 20a of the Bundesgesetz über die direkte Bundessteuer (Swiss Direct Federal Tax Act [DBG]) that became valid on January 1, 2007, was first presented in November 2006.**

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The draft has been heavily modified once again as a result of the consultation procedure involving the cantons, the Swiss Tax Conference and some business associations. According to the information at our disposal the final version has now been completed. As has been the case up to now the main feature distinguishing an indirect partial liquidation is the sale of shares representing at least 20% of the nominal capital of a limited company or cooperative from a seller's private assets to the business assets held by another natural person or legal entity. If within five years of such a sale nonoperational assets distributable under commercial law are paid out and if the vendor knew or ought to have known that such assets were being permanently removed from the company, then this represents a case of indirect partial liquidation. If an indirect partial liquidation has been carried out, the gain realized (in whole or in part) is recategorized and instead of being a tax-free capital gain subject to Art. 16 para 3 DBG it is deemed to be taxable asset income subject to Art. 20 para. 1c DBG. As well as serving to define significant terms such as qualified participation, change of system, distribution, reserves distributable under commercial law, nonoperational assets, and cooperation, CS 14 also clarifies the text of the Act more precisely where necessary. As a result of the protracted consultation procedure – it has lasted almost eleven months leading to twelve different versions of the text – some substantial changes have been introduced into the Circular.

### Qualified participation

This stipulation applies to sales transactions by individuals in Switzerland with unlimited tax liability and does not affect foreigners.

Qualified participation may be said to occur if a number of natural persons domiciled or resident for tax purposes in Switzerland individually holding less than 20% of shares combine to sell and the total of assets sold reaches the 20% threshold. Consensus among the parties is required for a mutual sale.

As far as employee-owned shares are concerned, sales of shares based on the employment relationship are not subject to Art. 20a DBG and are not subject to the stipulations governing indirect partial liquidation.

### Assets distributable under commercial law

The assets distributable under commercial law are composed of equity less the share or nominal capital less the maximum reserves required by legislation. Hidden reserves are not taken into consideration.

A new feature is that loans or securities may be granted on the basis of the purchase if the value of such conforms to the arm's length principle. It will only be assumed that assets have been withdrawn if the company forms reserves or has to write off assets. If the securities are drawn on, a check will be made to see whether the funds were financed from current profits or company assets.

Dividends are freely distributable from

the target company's distributable regular annual profit from the year of the sale. The cut-off date for valuation is the date the undertaking was agreed.

### Nonoperational assets

Assessment of whether assets are operational or nonoperational is made when the dividend is paid retrospectively to the date the undertaking was signed. The economic criteria and the actual purpose of the company are determinant. The fixed and current assets are the subjects of this assessment.

### Cooperation

Basically nothing has changed with respect to the definition of cooperation. Cooperation is said to take place if the vendor knows or ought to have known that assets were permanently withdrawn from the company to finance the purchase price. Such cooperation can be active, by granting a loan for example, or it can be passive, in that the vendor is aware that the purchaser has insufficient funds to finance the purchase price. The Decisions of the Federal Supreme Court cited in the paragraph in the Circular dealing with cooperation should continue to be used to interpret whether cooperation exists or not, however, they are not to be used for the interpretation of other relevant elements.

The amendment concerning public takeover bids is also worthy of mention. According to CS 14, for a mutual sale to take place mutual consent is required. This rule cannot be applied to public takeover

bids. However, the right to apply it in special cases is reserved, in which case a separate audit may be required, e.g. sale of shares by a majority shareholder of a quoted company.

#### Legally binding information

Inquiries to the tax authorities before a sale may only be made about the situation at the relevant point in time and concerning the existence of a sale, change of system, deadlines, assets distributable under commercial law and qualified participation. Further information may be obtained about facts in connection with the distribution itself if this is to take place in parallel with, or soon after, the sale of assets. Information about nonoperational assets will only be given if the vendor intends to distribute assets immediately after the sale or if companies wish to merge.

In the amended version of Circular 14 the Federal Tax Authority clearly distances itself in practice from the Federal Supreme Court decision of June 11, 2004. All in all, the amendments mentioned are steps in the right direction from an economic perspective and should therefore be welcomed. Nevertheless, there are still some obstacles that should not be underestimated. ■

## New Practice to Avoid «Tax Allocation Losses»

**In the last three years the Federal Supreme Court ruled in three decisions regarding real estate ownership in different cantons that tax allocation losses (German: *Ausscheidungsverluste*) were contrary to the principle that taxation should correspond to people's and company's economic capacity. Such tax allocation losses can occur if a tax loss is allocated to the canton of domicile, which is then not accepted by the other canton where the real estate is situated although a net income is achieved in this canton. Based on this decisions the Swiss Tax Conference of Cantonal Tax Officials has now published a new Circular letter regarding avoidance of tax allocation losses in July 2007.**

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#### Overview of Federal Supreme Court decisions

As general rule, gains on sale of real estate held as business asset are taxed exclusively in the canton where the property is situated. On the basis of the Federal Supreme Court decision of November 19, 2004, the canton where the property is situated now has to take into account any losses incurred in the canton of domicile and in other cantons where the company has permanent establishments. This has to be effected regardless of whether capital gain from real estate is subject to real estate capital gains tax (monistic system) or whether it is subject to regular corporate income tax (dualistic system).

Furthermore, in its decision of April 18, 2005, the Federal Supreme Court determined that the canton where the privately held real estate is situated has to accept any excess of tax-deductible expenses incurred in the canton of domicile.

In the decision of May 8, 2006, the Federal Supreme Court rejected the application of the tax allocation loss principle in a case concerning investment property. Now the canton where the real estate is situated is obliged to take the company's situation and economic capacity into consideration. Losses in the canton of the company's domicile or in other cantons where real estate is owned have to be accepted and used in the calculation of the

corresponding income and gains from real estate. This new interpretation puts an end to any potential double taxation on real estate held as an investment that may have existed up to now.

Based on this practice tax allocation losses should no longer be incurred on either privately held real estate or real estate held as business asset (operational or investment assets). If as a result of owning real estate a taxpayer is liable for taxation in various cantons, the cantons are obliged to effect the intercantonal tax allocation in a way that losses at the company's domicile (or in other cantons where real estate is owned) are respectively considered in the calculation of taxable income and gains from real estate. This requirement for losses to be taken into account arises directly from the constitutionally derived prohibition on intercantonal double taxation.

However, in its decisions the Federal Supreme Court has not yet indicated how exactly the intercantonal tax is to take place where such losses occur. Therefore it was still unclear whether acceptance of the loss by cantons where real estate is situated would be final or whether it would be possible to retransfer such losses (retrospective loss transfer) at a later date if a profit arises at the domicile (or in a canton where real estate is situated).

### New Circular letter from the Swiss Tax Conference of Cantonal Tax Officials

The Swiss Conference of Cantonal Tax Officials has long been considering drawing up appropriate Circulars on the matter of compilation of losses for owners of real estate in various cantons.

In July 2007 the first Circular letter was published («Avoidance of tax allocation losses», Circular letter 27 of March 15, 2007) in which the tax allocation of losses from privately held real estate and from real estate held by legal entities (with both operational and investment assets) was ruled.

Consultation is still proceeding on the tax allocation principles for deduction of losses by pure real estate companies and real estate brokers.

Based on the above-mentioned decisions of the Federal Supreme Court, the Circular letter of March 15, 2007, determined the following principles of intercantonal tax allocation to avoid tax allocation losses:

- Losses and excess tax-deductible expenses in cantons where the real estate is owned (investment real estate) will be allocated according to the quota of the operating result of all respective cantons
- Cantons where real estate is owned (investment real estate) have to offset a negative overall operating result with income and profit from real estate (regardless of whether or not real estate capital gains are taxed with a separate real estate capital gains tax [monistic system])
- If an overall loss occurs there must be effected no allocation for income tax purposes, instead the loss is to be carried forward to the next fiscal period (and to be allocated in line with the respective intercantonal quotas of this period)
- The loss has to be accepted as final
- No retrospective transfer of losses accepted (neither the main tax domicile nor the canton where the real estate is situated may retrospectively transfer

- losses to another canton once such losses have been accepted)
- The new rules for tax allocation losses apply from the 2006 fiscal period (on request the rules may be applied to earlier fiscal periods for which a final assessment has not yet been issued)

It should be noted that the Circular letter only defines approaches to be used to avoid tax allocation losses. Despite differences to the contrary in cantonal taxation law (e.g. AG, SG, SO, ZG) the cantons in principle agree that losses should be accepted as final and that retrospective transfer of accepted losses – as was practiced in the past – should no longer take place.

### Unsolved problems

Although numerous provisions and actual cases are shown in the Circular letter such will not be sufficient to clarify every single question that may arise. In complex cases it should therefore be assumed that a discussion with the tax authority will be required.

In actual practice it would be necessary to determine whether a negative business result, which will become apparent at the end of the year, will be qualified as a «new fact» making it possible to revise a previously issued final assessment for separate real estate gains tax (monistic system).

Because of a lack of publications on this issue it is not yet clear if the new rules for dealing with tax allocation losses fully apply to pure real estate companies and brokers.

Finally in connection with retrospective transfer of losses, the question arises whether in view of the differing cantonal tax laws it contravenes new (unwritten) law (avoidance of intercantonal double taxation) and whether it is unenforceable.

### Conclusion

According to the Federal Supreme Court's decisions no tax allocation losses may occur in future. The new tax allocation

rules based on the Swiss Tax Conference's Circular letter are already applicable for 2006 and on request by taxpayers may be applied to other fiscal periods for which no final assessment has been issued.

Taxpayers who own real estate in different cantons are well advised to have fiscal periods, for which no final assessment has been issued, checked and to apply with tax authorities to have respective allocation of tax losses. This may help taxpayers to avoid taxation of income and gains from real estate in case of existing overall tax losses. ■

## Switzerland joins the Hague Convention on the law applicable to trusts and on their recognition and issues a nonbinding Directive on trust taxation

**On July 1, 2007, the Hague Convention on the law applicable to trusts and on their recognition (The Hague Trust Convention) has entered into force in Switzerland. This is a major step for the trust business in Switzerland but does not mean that the trust has been integrated into the Swiss Civil Code or into a specific Swiss Trust Law.**

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The ratification of the Hague Trust Convention sets the standards of recognition of foreign trusts in Switzerland. The taxation of trusts remains outside of the scope of the Hague Trust Convention, each contracting state will have its proper rules on trust taxation. As far as Switzerland is concerned, the trust as such is not a tax subject for income and wealth tax purposes, nor is the Swiss resident trustee taxed on the trust assets and the income/capital gains generated by the trust assets. However, the Swiss resident settlor and/or the Swiss resident beneficiary may potentially face taxes. With the purpose of harmonizing divergent cantonal tax practices, the Swiss Tax Conference has issued a non-binding Directive on trust taxation which will give some guidance to the tax authorities and the tax payers (settlors and/or beneficiaries).

Briefly, the nonbinding Directive makes a distinction between revocable and irrevocable trusts. The creation of a revocable settlement by a Swiss resident settlor is not assimilated to a gift, the settlor is deemed to retain the control over the trust assets and consequently trust assets and income therefrom continue to be attributed to him for tax purposes. The settlement into an irrevocable fixed-interest trust by a Swiss resident settlor is assimilated to a taxable gift. As regards the Swiss resident beneficiary of a foreign trust, the Directive makes a distinction between the beneficiary of a fixed-interest trust and the beneficiary of a discretionary

trust. The beneficiary of a fixed-interest trust will pay income taxes as and when trust income is earned, capital gains remain tax exempted, and the beneficiary of a fixed-interest trust will face net wealth tax on the portion of the trust assets which has generated the trust income attributable to the beneficiary. The beneficiary of a discretionary trust will pay income taxes on the distributions (be it out of trust income or capital gains) when actually received, he will not face net wealth tax on the trust assets generating the income and/or the capital gains finally distributed to the beneficiary. ■

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