

Tax News

March 2008



Dear Reader

On February 24, 2008, the people gave the corporate tax reform II their vote of approval.

After 17 cantons had managed to reduce the burden of double taxation imposed on businesses, it was now time for the problem to be sorted out across the board at the federal level. That is what corporate tax reform II does, with dividends being taxed at 60% on shares held as private assets, and at 50% on shares held as busi-

ness assets (planned coming into force 1.1.2009). The Tax Harmonization Act now expressly gives the cantons the authority to use, in the same way, partial taxation as a way of reducing the double taxation of corporations and shareholders which results from the taxation of profits made by the company and the one of those distributed to the shareholder (latest coming into force 1.1.2011). Just how much relief is to be given is left to the cantons themselves – in line with their constitutional prerogatives – but it applies only to shareholders owning at least 10% of a company. The effect of this limitation is a relief for owners of businesses and the entrepreneurially active partners in small and medium-sized enterprises.

The burden of double taxation of distributed business profits is also lightened by extending tax relief with respect to dividends (planned coming into force 1.1.2011). A company must now own only 10% (as opposed to the former 20%) of another company, or, alternatively, the latter must have a market value of CHF 1 million (rather than CHF 2 million) to enable it to claim the tax relief with respect to dividends. The same 10% quota for holdings also applies to the tax relief for capital gains on shareholdings.

Another change is that the cantons are now able to credit corporate income tax against capital tax, and the decision as to whether or not to introduce that arrangement is to be left to them (planned coming into force 1.1.2009).

A further significant point is the introduction of the principle of contribution of capital for shareholders. Capital contributed to a company by its shareholders

later than January 1, 1997, is now repayable without liability to tax, even if it was contributed in the form of deposits or subsidies (planned coming into force 1.1.2011). Until now, this sort of repayment of capital was taxable as income, at any rate at the federal level. The FTA has announced that a circular on this subject is going to be issued.

Finally, we note that reliefs are to be introduced for succession to businesses by partnerships and the self-employed.

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US tax desk: recent developments

In order to prevent the US heading into a recession, President Bush signs the economic stimulus bill. Further the appeals court rules for government on the filing deadline for foreign corporations.

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President Bush signs economic stimulus bill into law

On February 13, 2008, President Bush signed into law a package of tax incentives designed to stimulate the economy. Amid fears that the US could be headed towards recession, the president and Congress are attempting to put money into the hands of businesses and individuals to avoid a recession completely.

Key features of the stimulus measures include:

- A cash rebate check ranging from \$300 to \$1,200 depending on filing status to be given to those individuals who paid taxes in 2007 or had at least \$3,000 of earned income. The amount of the rebate check will be reduced for those individuals with \$75,000 or greater of adjusted gross income (\$150,000 for married taxpayers filing a joint return), and gradually phase out to the point where no rebate will be paid for individuals without children who have adjusted gross incomes of \$87,000 or greater (\$174,000 for couples filing jointly with no children).
- Businesses will be allowed to deduct 50% of the cost of new equipment bought after December 31, 2007, and placed into service during 2008.
- Businesses will be allowed a current year writeoff for new equipment under the US Tax Code Section 179 rules up to \$250,000 from \$128,000 with the phase-out threshold raised from \$510,000 to \$800,000.
- To stimulate more mortgage lending, the limits on government-sponsored enterprise conforming loans and Federal Housing Administration-insured loans are increased for 2008 to \$729,750. The limit on Federal Housing Administra-

tion-insured loans had been \$367,000, and the limit on conforming loans eligible to be purchased by Fannie Mae and Freddie Mac had been \$417,000.

Appeals court rules for government on filing deadline for foreign corporations

The US Third Circuit Court of Appeals reversed a 2006 lower court ruling, *Swallows Holding, Ltd. v. Commissioner*, that challenged the validity of a US tax regulation requiring foreign corporations engaged in a US trade or business to file a US federal income tax return within 18 months from the normal due date of the return in order to maintain the right to claim deductions against gross income. The decision is significant in particular for those foreign corporations that do not believe themselves to be engaged in a US trade or business but nevertheless file a “protective” return in order to be able to claim US tax deductions should the IRS challenge the taxpayer’s assertion and prevail. Additionally, foreign corporations that rely on a US income tax treaty to avoid US taxation on US trade or business income because of a lack of a US permanent establishment may also be affected.

It is advised that those foreign corporations currently not filing a US federal return, either because they have viewed themselves as not having a US trade or business or are so engaged but lack a US permanent establishment, reconsider whether to file at least a “protective” US return. ■

Germany: current trends

New developments in German taxation center around four issues. The European Court of Justice (ECJ) has ruled that the switchover clause does not breach European law. In the Lidl Belgium case, the advocate general is applying to the court for the deduction of losses sustained by foreign permanent establishments to be allowed. We are now awaiting the ECJ's final ruling. The supplementary protocol to the double taxation agreement Germany – USA has entered into force, and the rules on taxation at source are now applicable retrospectively from January 1, 2007. The Annual Tax Act (JStG) 2008 has also been promulgated.

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Switchover clause in German CFC rules conforms with EU law

In Germany, revenues from permanent establishments abroad, for example in Switzerland, are usually tax-exempt with reservation as to progressive tax rates. Alongside some restrictions on activities – in the German/Swiss DTA for example – there was in the German controlled foreign corporation (“CFC”) rules (Article 20 para. 2, which became known as the “switchover clause”), a provision to the effect that certain capital revenues from the foreign company would not enjoy exemption, but that the tax credit method would instead apply to them. The effect of this is that such revenues from permanent establishments are – with foreign taxes credited – “upgraded” to the German tax level.

On December 6, 2007, in the case *Columbus Container Services BVBA & Co.* (C-298/05), the ECJ ruled that the German “switchover clause” does not breach European law, and this also impacts the current legal position of Article 20 para. 2 of the German CFC rules, in which the provision on certain capital revenues was extended to the instances mentioned in Articles 7 et seq. of the same act. Care still, then, has to be taken to ensure that permanent establishments abroad (in Switzerland) are “actively engaged in business” if they are not to lose, when taxed in Germany, the tax benefits conferred on foreign investments by the “switchover» rule. However, with the right structures, it is possible – even in the event of a “switchover” to the tax credit method

– to avoid German trade tax, which, since the business tax reform in 2008, accounts for almost 50% of the tax imposed by Germany on business income. The result would be that, despite the changeover to German business income tax, which is thought of as being more onerous, only German corporation tax plus solidarity surcharge would be payable at 15.825%, to which foreign taxes would be credited.

ECJ: final submissions in the Lidl Belgium case (C-414/06)

In the Lidl Belgium case before the ECJ (C-414/06), the advocate general made her final submissions on February 14, 2008. In this dispute, the ECJ is being asked to clarify whether the absence of the option for setting off the losses sustained by foreign permanent establishments against the profits of the German parent company is in breach of European law. The treaty provision at issue (Article 23 A para. 1 fig. 1 of the OECD model convention) grants tax exemption for profits from permanent establishments in the country in which the parent company is domiciled. On this basis, the German tax authorities and the highest German tax court, the *Bundesfinanzhof*, conclude that losses from the foreign permanent establishment do not have to be set off in Germany either (although they can have an effect on the tax rate applied). The advocate general, by contrast, sees this as violating the right to freedom of establishment, but it remains to be seen whether the ECJ will take the same line; on November 6,

2007, it ruled in the case of *Stahlwerke Ergste Westig* (C-415/06) that not setting off losses from permanent establishments in third countries – such as Switzerland – do not constitute a violation of the right to the free movement of capital. It remains to be seen whether the ECJ will come to a different conclusion by applying the freedom of establishment test.

Supplementary protocol to double taxation agreement Germany – USA ratified

The protocol amending the double taxation agreement between Germany and the USA was signed on June 1, 2006, and entered into force on December 28, 2007. Among other things, it has been agreed that, in order to avoid the multiple taxation of profits, the levying of tax at source on the profits distributed by subsidiaries to their parent companies should be dispensed with, one precondition for which is that the latter should have had a direct stake in the former of at least 80% for at least 12 months. The rules in the protocol apply retrospectively to taxes at source with effect from January 1, 2007.

Annual Tax Act (JStG) 2008 promulgated

On December 28, 2007, the Annual Tax Act (JStG) 2008 was promulgated; one of its effects is to restrict, in line with the ECJ ruling in the case of *Cadbury Schweppes* (C-196/04), the notional fiscal transparency assumed by German foreign tax law on foreign limited companies. This ruling states that CFC rules are ineffective if a foreign company based in the EU or the EEA demonstrates that it does actually engage in business activity in the foreign state, so that its profits are not attributed to its shareholders, and so that the foreign company instead acts as a shelter in the customary way. As this new rule does not, however, apply to foreign establishments, the tax credit method (Article 20 para. 2 of the Foreign Tax Relations Act, q.v. also above) continues to be applicable. This is a positive development, albeit one from which Switzerland, being what is known as a “third country,” does not benefit. ■

Taking hold of global mobility risk

In the marketplace we see an increasing likelihood of global mobility risks materializing and also a greater impact of these risks when sending employees abroad. This should move the evaluation of global mobility risks higher up on the agenda of tax directors.

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The business world is getting more interconnected than it has ever been. Globalization is gathering pace; trade and capital flows are becoming more complex as emerging markets begin to fulfill their potential; legacy business models are being left behind as companies find new ways of organizing their activities for maximum efficiency; and in many sectors competitive pressures are forcing consolidation and a wave of M&A activity. All this in an environment in which regulatory and stakeholder pressures increase for multinationals seeking to manage all aspects of risk. Against this background, multinationals are requiring more global mobility: more people, moving to and from more countries, in more combinations of roles and structures than ever before. The risks of operating a globally mobile workforce are multiplying, and so is the likelihood of those risks materializing, with all the negative results that that implies.

To manage global mobility risk appropriately requires a holistic approach, involving HR, tax and legal support teams (such as payroll) and operating units. Global mobility risk may not be the first thing an audit committee thinks of when it is considering the quality of the company's risk management, but there is a real and in our view growing global mobility component to major aspects of business risk.

Financial: In our Global Tax Risk Survey, the number one priority for tax directors was ensuring that correct tax numbers and disclosures appeared in the accounts. Expatriate-related tax positions that turn out to be incorrect mean more than a cost in interest and penalties in the local jurisdiction. For countries subject to SEC rules, restatements are a major embarrassment, and for the individuals concerned at a local

level, fines, loss of assets, incarceration or worse can ensue.

Legal/compliance: Failing to comply with local regulations or getting that compliance wrong can seriously hinder moves into new markets and expose the business to legal challenges from employees, partners or the authorities. Non compliance with local immigration law risks withdrawal of visas, deportation, or even imprisonment for the individuals, making business more difficult not just at that point but probably for months or years afterwards.

Reputational: In an age of stakeholder activism, activities that can be perceived as doubtful, however flimsy the charges, can contribute to loss of reputation and eventual loss of value. No business wants to be seen (either knowingly or through negligence) as careless of its people or engaged in breaches of legislation, or for top executives around the world to be viewed as such.

Real-life examples

The following shows just a few examples of risk situations that we encounter in the marketplace.

Not planning immigration and tax together: A company that brings workers into Australia without considering the tax implications of the kind of work permit used has tax exposures as a result. Anyone entering Switzerland to work should be aware that the immigration and tax databases are linked, so it is important to deal with both issues simultaneously to avoid anything going wrong.

Getting split payroll arrangements wrong: When the authorities in one East Asian country discovered a senior company executive had failed to declare the HQ element of his salary for years, the result was not only damaging to the company's

reputation, but it sparked the further uncovering of more senior executives who had also been in this position, costing the company millions of dollars in back taxes.

Just not having a strategy for global mobility: We are aware of a business that allowed its executives to put their own mobility programs together and supported them with very generous benefits. Recognizing the value to the employee of employee-initiated relocations enabled the company to cut substantially the costs associated with these moves.

Proactive risk management

Proactive global mobility risk management can potentially add enormous value. Implemented effectively, not only can it help identify current areas of significant risk and default, and allow for swift remediation, it can aid planning and help spot opportunities to maximize efficiencies.

For an approach to succeed, however, it needs to be driven by the business strategies and objectives, and reflect the processes and initiatives that exist to achieve these objectives. It also needs to identify clearly the people who must be involved; the processes and policies that should be covered; and if possible the flashpoints that the team already knows are, or could be, causes of concern or areas of conflict.

Conclusion

Managing global mobility risk is complicated by the tension between the needs and issues of the employer, employees and vendors. All have to be balanced by the risk assessment, and processes built which make it easier for all three to operate seamlessly and efficiently. Communication and information exchange is the real key to success, but the difficulty of surfacing everything that's out there should not be underestimated. A consistent, clear methodology for identifying and handling risk will go a long way to ensuring that policies and procedures are working as they are intended to, ensuring compliance and avoiding costly risks. ■

Corporate tax reform II: wages versus dividends

Are the people in charge of AHV going to change the wage on which their calculations are based?

February 24, 2008, saw the adoption of the second corporate tax reform, with 50.5% voting in favor of it. This reform will make Switzerland a better business location for SMEs. With the federation and the cantons each bearing a part of the decline of the taxation of dividends, the idea is to lighten the burden of double taxation on the distribution of company profits.

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How did it work up to now?

Under the former tax regime, company profits distributed to shareholders were taxed twice (in a row). First, the company paid taxes on its profits; then, what was left after taxes had been deducted was distributed among the shareholders in the form of dividends. This was accounted as income for the shareholders, and they were liable to tax on every cent of it.

What is going to change?

The second corporate tax reform effects, regarding dividend distributions, that the federation will tax only 60% of the nominal value (when the shares are held as private assets) or 50% (when they form part of business assets), the idea being that this will reduce the double taxation burden (planned coming into force 1.1.2009). However, this rule applies only when the owner of the shares has a stake of over 10% in the company.

What are the consequences?

Up to now, firms have kept their profits within the company in order to avoid double taxation. The corporate tax reform reduces the effects of double taxation, and for this reason more efficient use is made of companies' capital and more money can be invested into new and innovative businesses. In the long term, this will generate more growth. In the short term, though, the second corporate tax reform results in some tax shortfalls, which, in terms of the lower level of dividend taxation, will amount to some CHF 56 million for the federation and about CHF 437 million for the cantons. Since

shareholders of companies will in the future have a bigger incentive to draw dividends rather than wages, there is expected to be a shortfall in AHV contributions between CHF 86 million and CHF 130 million.

Wages or dividends?

The prospect of a shift away from wages towards dividends raises the question of how the social insurance authorities are going to react. Will the AHV offices adjust the wage on which their calculations are based?

The social insurance authorities are entitled to adjust earnings and the amount of AHV contributions payable. This is confirmed by a ruling from the Federal Insurance Court in 2000, according to which the social insurance authorities are bound to prevent normative wages being falsely declared as investment income in order to avoid the payment of contributions.

If the tax authorities have not yet produced a final assessment of the shareholder, both they and the social funds can, in the event of a discrepancy between performance and consideration, consider very high dividend payments as wages on which contributions are payable. However, if the shareholder has already been assessed for taxes, it is likely to prove difficult to levy additional taxes or revise the assessment. But one can expect shareholders in SMEs to continue, despite their tax rebate, to have the companies pay them a wage of around CHF 110,000 in order to secure themselves the maximum AHV pension.

It also needs to be borne in mind that restrictions are placed on the strategy of

paying out high dividends. In the first place, an increase in dividends is not so simple to arrange on the basis of the equity holding ratios, since the non working shareholders are also entitled to benefit from any increase. Second, any reduction in salary also entails a reduction in the overall social insurance cover in the second pillar, for which switching to Pillar 3a cover can do little if anything to compensate.

Conclusion

The answer to the question as to how much an entrepreneur should pay out as wages or as dividends depends on how carefully he has done his tax planning, in which respect the effective planning of retirement provision in particular must not be overlooked. ■

Severance pay: a comparison of taxation principles in Switzerland and abroad

On January 12, 2007, the tax court of Basel-Landschaft ruled (ruling No. 2/2007) that severance pay is, under certain circumstances, to be taxed in the recipient's domicile.

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Taxation principles as laid down by the Direct Federal Tax Act (DBG)

The court ruling referred to above relates to a capital payment that is neither a lump-sum payment from an employment-related pension plan nor a similar payment from an employer (a severance payment having the nature of a benefit) as described in Article 17 para. 2 of the DBG. It is rather to be considered as an "other lump-sum payment" (a severance payment as a substitute for income or as compensation for the abandonment of an activity of the kind described in Article 23 (a) and (c) of the DBG). It is therefore to be taxed together with the other income under Article 214 (or Article 36) of the DBG and, if necessary, in conjunction with Article 37 of the same law at the tax rate that would apply if, instead of a one-off payment, the same amount were to be paid on an annual basis.

International aspects of the taxation of bonus payments

In an international case (Federal Supreme Court decision of February 15, 2001, in: STE 2001 B 11.2 No. 6) relating to bonus payments and involving Switzerland and the UK, the Federal Supreme Court ruled that, in international taxation, tax should be levied at the location at which the work in question was done, irrespective of whether, at the time the payment is made, the recipient is still employed at that location or of his or her domicile. In this particular case, the recipient was domiciled abroad at the time the payment was made, while the work in respect of which it was made had been done in Switzerland. The reasoning given is that the payments made are to be regarded as remuneration after the event for services rendered, an entitlement to which had

been established at the time of the former employment.

The same conclusion was arrived at in another case – also involving the UK and Switzerland – by the Tax Appeal Commission of the Canton of Zurich, although in this instance the relative positions of the domicile and workplace were the other way around (decision of Tax Appeal Commission I of the Canton of Zurich, December 15, 2000, in: STE 2001 A 32 No. 5).

The Tax Court in Basel-Landschaft came to the same conclusion as regards the link with past employment, albeit in a Switzerland/USA case involving the exercise of options (ruling of the Basel-Landschaft Tax Court [StGE] No. 101/2003 of October 10, 2003, published in BStPra XVII, p. 131 ff.).

International aspects of the evaluation of severance pay

The ruling by the Tax Court of the Canton of Basel-Landschaft referred to above was handed down in a case involving a salaried employee, domiciled in Switzerland but formerly having been employed in the UK, who received severance pay as a consequence of restructuring measures. It was held that severance pay can be treated as analogous to bonus payments in legal practice only if the lump sum is comparable in terms of its function with a bonus payment and therefore constitutes a form of continued salary payment.

The payment in this case, however, was held not to be founded upon an entitlement acquired during past employment in the UK, but upon an entitlement conferred by a social plan, and one that would come into being only in the event of the employment being terminated and would be intended to compensate for the loss of future earnings.

On those grounds, it was Switzerland alone, being the state of domicile, that was entitled to levy tax, rather than the state in which the former employment had been carried out.

Conclusion

It can thus be seen – following on from the ruling of the Tax Court of Basel-Landschaft on the payment of severance pay – that it is the actual character of the payment in each individual instance that needs to be examined.

If it is in some sense a continued payment of a salary earned in the past, the power to tax it lies with the state in which the work location is situated.

If, however, there is no connection with an earlier period of work and it constitutes a payment for future shortfalls made in accordance with a social plan, it is to be taxed in the country of domicile at the time the payment was made, irrespective of where the work was done in the past. The fact is that, in this instance, the lump sum is not related to the work previously done abroad, as is required if a foreign place of work of the kind required by the applicable double taxation agreement is to be demonstrated.

The view of such payments taken by Switzerland is not always identical with that taken by the foreign state in question. It is for that reason that it is, in individual cases, of the utmost importance that the tax treatment be, if at all possible, agreed on in advance, in order to obviate from the very outset what amounts to double taxation or, alternatively, a time-consuming mutual agreement procedure. ■

Intercantonal allocation of lump-sum tax imputation Administrative practice in the cantons

The new circular No. 31 of January 18, 2008 from the Swiss Tax Conference lays down the administrative practice in the cantons with regard to the apportionment of lump-sum tax imputation to various tax domiciles. This will ordinarily affect natural persons, partnerships and legal entities.

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Background

States, as a matter of regular practice, levy tax at source on distributions of dividends, license and interest payments to foreign creditors. The beneficiary is often unable to claim back this withholding tax. If the applicable double tax treaty (if any) does no more than reduce the tax levied at source, then the remaining tax is a definitive tax burden in the form of a foreign base tax.

Where a person, partnership or legal entity has more than one tax domicile in Switzerland (i.e. a main, a secondary and a special tax domicile), the question arises as to whether the main tax domicile should be obliged to bear the foreign base tax alone or whether its apportionment to all the tax domiciles in the various cantons can be demanded.

The Swiss Tax Conference's new circular No. 31 of January 18, 2008 (which entered into immediate effect) discussed this issue and laid down the administrative practice in the cantons with respect to the apportionment of tax imputed as a lump sum to the various tax domiciles.

In essence, the circular applies to natural persons, to all persons engaged in business whether as partnerships or sole traders, and to legal entities, although no apportionment among the cantons takes place in the case of natural persons. The canton of residence is to bear the whole sum imputed. The following explanations regarding the allocation in the case of legal entities apply analogously to partnerships and sole traders.

Legal entities: basic rules

In the case of legal entities, it is in principle the canton in which the entity has its reg-

istered office that has to impute the lump sum, although in economically significant cases, application may be made for apportionment among the cantons in which the company has its secondary Swiss tax domiciles. It is to be noted that, under the terms of the wording of the circular, the sum may be allocated only among the cantons in which the company maintains establishments and/or has its secondary tax domicile(s). Special tax domiciles are not required to be taken on any amount of imputed tax. A case shall be regarded as economically significant if each canton in which an establishment is situated must bear at least CHF 5,000 of the tax lump sum imputed.

Calculating the apportionment

In principle, only the canton's share of the lump sum imputed (normally 2/3 of the total base tax imputable) shall be included

in the apportionment. In the case of all businesses, the intercantonal allocation shall be carried out only on the same basis as that on which tax on profits is allocated. If the amount to be imputed exceeds the tax owed on profits in the canton in which the establishment is situated, that canton shall be required to bear the tax imputation only up to the amount of the corporate income tax owed.

Example

The manufacturing company Kiwi AG (hereafter Kiwi) has its registered office in Bern and operates establishments in the cantons of Zurich, St. Gallen and Ticino. Kiwi also owns a piece of real estate for investment purposes in Geneva, as well as a profitable subsidiary in New Zealand, from which it received in 2007 a dividend in the amount of CHF 1 million. This dividend is subject in New Zealand to a final withholding tax at the rate of 15% (CHF 150,000), and the applicable double tax treaty between Switzerland and New Zealand makes provision, for the purpose of the avoidance of double taxation, for this sum to be imputed to the sum of corporate income tax owed in Switzerland.

The intercantonal allocation among the cantons of the amount to be imputed is calculated as follows:

Taxable net income	1,500,000
Allocation of proceeds from real estate in Geneva	100,000
Profit to be allocated	1,400,000
Total amount to be imputed	150,000
Federation (1/3)	50,000
Cantons/Communities (2/3)	100,000

	Quota*	Net income	Tax burden	Imputation	Levy	Actual imputation	Tax owed
Bern	60%	840,000	159,600	-60,000	-3,000	-63,000	96,600
Zurich	30%	420,000	77,700	-30,000	-	-30,000	47,700
St. Gallen	7%	98,000	14,700	-7,000	-	-7,000	7,700
Ticino	3%	42,000	7,900	-3,000	3,000	-	7,900
Geneva	-	100,000	23,500	-	-	-	23,500
Total		1 500,000	283,400	-100,000		-100,000	183,400

* Profit allocation (assumed)

The canton of Bern can make an application demanding of the cantons of Zurich and St. Gallen the apportionment of the sum imputed.

No apportionment to the canton of Ticino is possible, as the CHF 5,000 minimum is not reached. The relevant amount must be borne by the canton in which the company has its main business address.

The profit from the real estate in the canton of Geneva (a special tax domicile) is allocated first, and the canton of Geneva is not required to bear any of the sum to be imputed. ■

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