

# Tax News



Dear Reader,

The Federal Council would like to strengthen Switzerland's competitiveness and appeal as a business location by introducing further measures in the domain of corporate tax legislation. For example, it tasked the Federal Finance Department with drawing up a consultation draft for Corporate Tax Reform III. In the area of shareholding deductions, the Federal Council intends to change the system by switching from indirect to direct exemption of shareholding income.

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Will Switzerland regain its position as an attractive site for internal corporate financing? The "10/20 rule" for non-bank lenders has long been viewed as one of the main barriers for conducting internal corporate financing within Switzerland. Any Swiss company that receives loans from over 20 non-banks is considered a bank for withholding tax purposes. As a result, it is required to withhold 35 percent of all the interest it pays to lenders as Swiss withholding tax. At the end of December 2009, the Swiss revenue offices reviewed their own rules in a formal hearing.

This issue of Tax News looks at these topics and other recent tax issues from Switzerland and abroad. The authors of the respective articles will be happy to answer any further questions you may have concerning the individual subjects.

We hope you find this issue thought-provoking.

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# Corporate Tax Reform III: A change of system for participation exemption?

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**The Federal Council would like to strengthen Switzerland as a business location and its competitiveness by introducing further measures in the domain of corporate tax legislation. Therefore it commissioned the Federal Finance Department to draw up a consultation draft for a Corporate Tax Reform III at the end of 2008. In the field of the participation exemption, the Federal Council intends to change the system by switching from the indirect to the direct exemption of participation income.**

## The current participation exemption system

### System of the indirect exemption of the participation income

According to the current system in force, income derived from qualifying participation is indirectly exempt from income taxation in Switzerland (Art. 69 DBG (Federal Direct Tax Act)). A qualified participation is an ownership of a stake of at least 20%, or if the fair market value is at least CHF 2 million (effective from 01/01/2011 amended conditions of a 10% shareholding or a stake in profits and reserves of at least 10% or a fair market value of CHF 1 million). However, the exemption of the participation income from the income tax only occurs "indirectly", through the participation exemption. Thereby, firstly the income tax is calculated on the basis of total taxable profit (incl. the participation income). Secondly, the income tax is reduced in the proportion of the net participation income (i.e. income minus administration and financing expenses) to the total taxable profit (Fig. 1).

### Problems of indirect exemption

From the point of view of the taxpaying entity the currently-valid system of the participation exemption is problematic. The major disadvantage of the existing system is that tax loss carry forward is offset against factual not taxable participation income. Equally disadvantageous is the fact that the values of the shareholdings have to be checked on an ongoing

basis, as pursuant to Art. 62, para. 4 DBG (Federal Direct Tax Act) impairments respectively depreciations on participations are allocated to taxable profit insofar as they are no longer justified. Furthermore, the acquisition costs of the participations are currently to consider, as only the capital gain arising from the sale of the holding in excess of the acquisition costs qualifies for the participation exemption. In addition, the deduction of pro rata administration and financing expenses from the participation income results in a dilution of the "tax-free" participation income and necessitates the use of a complex calculation model.

## Participation exemption system in the future / planned (Corporate Tax Reform III)

### System of the direct exemption of participation income

Due to the switch towards the direct exemption (as is takes place in most countries), participation income would be deducted directly from taxable profit via divisional accounting (Fig. 2). As a result, any tax loss carry forward would no longer be offset against participation income. Furthermore neither valuation allowances nor depreciations would have to be checked for its business-related justification and acquisition cost would no longer have to be determined either. On the other hand, valuation allowances respectively depreciations on participations would no longer be deductible from taxable profit (this can result in a significant tax disadvantage compared to the

**Fig. 1: Participation exemption (indirect exemption)**

Amounts in CHF	
Taxable income	3000.-
of which participation income	2000.-
Flat-rate administrative costs (5%)	- 100.-
Interest on debt (assumed)	- 100.-
<b>Net participation income</b>	<b>1800.-</b>
Income tax without exemption	255.-
Minus: Participation exemption (60%)	- 153.-
<b>Income tax due</b>	<b>102.-</b>

**Fig. 2: Income tax calculation with shareholding division**

Profit split	Profit	Shareholding division
Amounts in CHF		
Total income	3000.-	
./. Participation income	- 2000.-	2000.-
Taxable income	1000.-	
<b>Income tax due (8.5%)</b>	<b>85.-</b>	

current system). This negative tax effect could be eliminated or at least reduced by the simultaneous introduction of a possible offsetting of losses from domestic and foreign group companies against taxable profit of the parent company.

Furthermore, the aim within the system of the direct exemption of the participation income is to abolish the minimum shareholding ratio as well as the minimum duration the stake is held. The deduction of pro rata financing and administration costs should also be abolished.

## Conclusion

By switching from the system of indirect exemption to direct exemption of the participation income, existing tax loss carry forward would no longer be reduced by the indirectly tax-exempt participation income. The current dilution of the participation exemption could also be countered. Furthermore, participation values and acquisition costs would not have to be checked anymore.

However, as described above, it is questionable, particularly in the case of value allowances respectively depreciation on participations, whether the desired goal, i.e. the elimination of tax barriers, can actually be achieved. Inclusion of the deductibility of losses from domestic and foreign group companies in the tax assessment procedure is also not without problems (provisional offsetting, return debits and updating of inventories).

## Schedule

The Federal Finance Department is currently drawing up a consultation draft, for which the date of publication is still open, according to information provided by the department itself. For this reason, no conclusion can as yet be drawn as to whether and how the system change in the taxation of participation income in order to eliminate tax barriers as proposed by the Federal Council will be implemented in the consultation draft.

## Internal group financing: will the 10/20 non-bank lender rule be put to the test?

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**The so-called 10/20 non-bank lender rule has always been perceived as a major obstacle in choosing Switzerland as a place for intra-group financing. With more than 20 non-bank lenders, every Swiss company is deemed to have client deposits (like a normal bank). This requires the company to levy Swiss withholding tax of 35 percent on all interest paid to its lenders. With a formal hearing launched late last December, the Swiss revenue authorities put their own regulation to the test.**

### **Will Switzerland become attractive again for intra-group financing?**

Late last December, the Swiss Federal Tax Authorities have launched a hearing procedure with respect to a proposed amendment of the Swiss withholding tax law. The proposed amendment relates to a regulation of the Swiss withholding tax law pursuant to which any Swiss corporate entity can become subject to Swiss withholding tax of 35 percent on interest paid to its creditors. Whilst interest payments on loans payable by a Swiss debtor are usually not subject to Swiss withholding tax, the Swiss debtor may nevertheless become subject to withholding tax if it accepts loans (by way of loan agreement or by accepting monies on current accounts) essentially from more than 20 debtors. Exceeding this threshold triggers the withholding tax duty on all interest paid on such loans. Particularly

in the ambit of intra-group financing (such as e.g. cash pooling arrangements or intra-group loans), this regulation was perceived to be burdensome and hindering. As a consequence, numerous proposals have been launched on the political level to discontinue this rule and to ease the way for a more practical approach towards group financing activities. In the meantime though, this regulation has prompted various Swiss companies to have their intra-group financing activities performed by foreign group companies.

The envisaged changes propose that all loan agreements and current account relationships between companies pertaining to the same group of companies (meaning all companies which need to be fully consolidated according to generally accepted accounting principles) would not be subject to withholding taxes.

This in itself seems to be a favourable proposal. However, the proposal also comes with a restriction attached to it:

The new regulation would not be applicable for Swiss-headquartered group of companies where a Swiss group entity had guaranteed a bond or debenture issued by a non-Swiss i.e. foreign group company. This raises two questions:

(i) Arguably, the vast majority of Swiss-headquartered groups have issued guarantees or keep-well-agreements for bonds or debentures issued by their foreign group financing companies. Consequently, the proposed simplification will fail to have an impact on a large number of Swiss-headquartered group of companies.

(ii) The wording of the proposal suggests that where a Swiss company pertaining to a Swiss-headquartered group has guaranteed a bond or debenture, which has been issued by an overseas subsidiary, the proposed simplifications would not take effect at all. However, for foreign-based groups with a company in Switzerland, which, in turn, guarantees for a bond or debenture issued by another overseas company, the favourable regulations would be applicable

Accordingly, the attending explanatory notes set out that small and medium sized Swiss group of companies without foreign-issued bonds on the one hand, and foreign groups with treasury operations in Switzerland, on the other, will profit from the proposed regulations.

During the course of the hearing procedure, it will be seen whether such unequal treatment (as regards Swiss groups of companies with bonds issued by foreign subsidiaries) will find approval or not. The question is virulent as the proposed changes should take effect as early as April 2010.

In case of questions or any other requires please do not hesitate to contact

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# Tax Improvements for Corporate Funding

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**This reform was actually supposed to be part of the Corporate Tax Reform III, which is still only known in broad outline. But the Federal Council wants to move quickly and enact tax relief for corporate funding this spring.**

What is the reform about? Today's tax regulations put hurdles in the path of intragroup as well as external financing. This affects cash management and cash pooling above all. As soon as the number of creditors exceeds 20, and total credit equals at least CHF 500,000.00 - not uncommon for medium-sized or large companies - the corporation's running accounts and loan accounts are to be treated as customer deposits or bonds for the purposes of the Withholding Tax Act and the Stamp Duty Act. Essentially, the corporation is treated as a bank for tax purposes; loan "issuances" are subject to stamp duty, while the debtor's regular interest payments are subject to 35% withholding tax. In international transac-

tions, it may not be possible to reclaim the full withholding tax, depending on the double taxation agreement. When the transactions are domestic, the taxpayer may not have a higher tax bill, but will still incur the administrative effort of managing tax charges and reclamations. No wonder more and more Swiss firms have moved their funding functions abroad, while their foreign counterparts have chosen not to locate funding operations in Switzerland. By amending the Regulation on the Withholding Tax Act and Stamp Duty Act, the Federal Council intends to exempt intercompany balances from stamp duties and withholding taxes under certain circumstances in order to once again attract more domestic- and foreign-controlled financial firms - and the jobs they bring - back to Switzerland.

This is a welcome, if long-overdue, change. It makes it much easier to efficiently manage intragroup credit positions and cash. The Federal Council is still debating whether the intercompany transactions should be restricted to transactions with the fully consolidated entities, as suggested by the government

agencies, or should also be extended to transactions with entities accounted for using proportionate consolidation or the equity method.

There is another point of contention: the Federal Tax Administration (FTA) plans to exclude any domestic corporations who procure funds abroad through bond issues from the amendment, provided the bond was guaranteed by a Swiss company within the same corporate group. Essentially, the FTA only wants to privilege those funds earned exclusively within the group - not funds procured through a foreign bond which, unlike a domestic bond, was never subject to Swiss withholding taxes or stamp duties. The exception affects many large Swiss corporations with guaranteed foreign bonds, who would thus be denied tax relief for corporate funding. The business community is demanding the opportunity to prove that foreign-procured funds will also be used abroad, so that they also can obtain relief as long as they provide the necessary proof. The Federal Council's decision was still not known when this article went to press.

## Federal Court decision 2C.893/2008 of 10 August 2009

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### Criteria for distinguishing between an amateur art collector and an art dealer

#### Description of the case

Mr. X, town planner architect, residing in the Canton of Vaud, developed a passion for collecting old posters. This hobby started when Mr. X was a student, and over time has taken an increasing importance in the life of the latter. His collection particularly expanded in the 1980's with the acquisition of a major collection of posters in 1982. The collector subsequently added to his collection with the purchase of new items, either by unit or by lot. From the end of the 1980's,

as his collector activity was significantly gaining importance, he retired from his professional activity to dedicate himself to his hobby, regular sales of posters helping him to finance his standard of living and family. He participated in numerous exhibitions all over the world, sometimes placing posters from his collection at the disposal of these cultural events.

On 15 March 2004, Mr. and Mrs. X filed their 2003 tax return, stating zero income and taxable wealth of CHF 2,982,888. Final tax assessment for fiscal year 2003, by the Vaud Cantonal Tax Administration, by considering the activities of Mr. X as commercial, calculated cantonal and communal taxes on a different basis: taxable income of

CHF 323,200 and taxable wealth of CHF 2,987,000; and federal direct income tax on the basis of a taxable income of CHF 321,300. The amounts considered correspond to the total sales of posters in the year 2003 after deduction of related expenses.

Mr. and Mrs. X appealed against the tax assessment. The Vaud cantonal tax authorities rejected the appeal and confirmed the commercial qualification of the posters sales in 2003, which was therefore generating taxable income. On appeal of the spouses X the cantonal court confirmed the first instance's decision. The spouses X contested the cantonal decision by way of appeal to the Federal Court.

## Preambles of the Federal Court

The legal question to be resolved by the Federal Court relates to the different fiscal treatment applied to private capital gains (non taxable) and commercial profits in capital emanating from the sale of movable assets (taxable). The Federal Court concluded that the activities of Mr. X could not be qualified as a pure hobby, but should be considered as an independent commercial activity for the following reasons:

### **Distinction between private wealth and commercial assets - review of legal precedents**

According to the Federal Court, the notion of independent commercial activity is of broad interpretation. Thus according to our supreme court, the private capital gains exempted from tax are only the ones generated on irregular basis by a private person or within the normal administration of the party's private fortune. The following elements allow to determine if the situation is one of independent commercial activity going beyond the simple administration of private wealth (ground 2.2):

- (i) the systematic and/or planned nature of the operations;
- (ii) the high frequency of transactions;
- (iii) the short duration of possession of the assets before their (re)sale;
- (iv) the close relationship between the independent (accessory) activity claimed and the training/education and main profession of the taxpayer;
- (v) the use of specialist knowledge;
- (vi) the involvement of a relevant amount of third-party funds for financing the operations;
- (vii) the reinvestment of the profits generated;
- (viii) the creation of a partnership.

It is important to highlight that, according to the Federal Court, each of the above factors can lead, either in conjunction with the others, or even singly if the respective event shows peculiar intensity, to define the existence of independent lucrative activity. Indeed, the criteria

listed above do not necessarily have to be fulfilled simultaneously to determine whether the assets have to be considered as commercial or private ones. The Federal Court cited a former case law where a wine collector was applied only one criterion of those mentioned (this court decision was heavily criticized by the doctrine; Swiss Federal Court decision 2A.66/2002 of 17 September 2002). In this judgment, the Federal Court confirmed that a unique sale of a part of a wine collection may be taxable if the nature of the operation (in this case large quantity of wines sold in the context of an event attended by professionals working in the wine industry) proves the existence of a systematic activity with the objective of generating a profit.

### **Analysis of the activities of Mr. X as posters collector**

It was accepted by the Federal Court judges that the activities of Mr. X were not limited to buying posters for addition to his collection but that he sold them regularly to museums or private persons in numerous countries and that, to this end, he had several bank accounts denominated in foreign currencies. Moreover the transactions were not isolated but enabled him to support his family and to finance the acquisition of new items. Finally, the circumstance that the appellant presents himself as a specialist with an international reputation led the Federal Court to opine that the latter had knowledge at least equivalent to that of a professional (Ground 2.5). The circumstances that Mr. X had started his collection as a personal hobby, that he did not keep accounting records, that he did not maintain an organization that can be strictly defined as commercial (partnership) or that he did not make use of third-party funding were not considered to be sufficient to outweigh the factors speaking in favor of an independent commercial activity, in this case of a genuine art dealer (Ground 2.7).

### **Practical impact of the Federal Court decision**

With this ruling, the Federal Court has confirmed its existing precedents relating to the distinction between self-employment and the administration of private

wealth, based on various elements that do not have to be simultaneously fulfilled to establish the existence of a taxable profit on the sale of movable assets. In our opinion, the rules set out by the Federal Court decision may sometimes plunge the taxpayer into uncertainty regarding the exact limit between self-employment and mere administration of private wealth. Thus a collector disposing of a major asset should pay special attention to the fiscal qualification of the operation, even if the latter has never sold elements of his collection in the past.

# Swiss Supreme Court issues landmark decision on currency translation differences

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**The Swiss Supreme Court issued a leading decision regarding the treatment of foreign exchange differences resulting from the translation of financial statements kept in a foreign functional currency into Swiss Francs. The Court held that such translation differences do not qualify as taxable income or tax-deductible expenses.**

## Background

Several Swiss legal entities do not keep their general ledgers in Swiss Francs (CHF) during the year. At year-end, these trial balances in foreign currency are translated into CHF statutory accounts in order to comply with art. 960 of the Swiss Code of Obligation. The translation normally leads to foreign exchange (FX) gains or losses ("translation differences") recorded in the profit and loss statement (P/L). Based on the principle of imparity applicable under Swiss GAAP, FX-losses are immediately expensed whereas FX-gains are deferred since they often qualify as unrealized FX-gains. So far, this treatment was also accepted for corporate income tax purposes.

## Decision of the Swiss Supreme Court

The Swiss Supreme Court decided (2C\_897/2008) that such translation differences (FX-gains and FX-losses) do not qualify as taxable income or tax-deductible expenses and need to be recorded directly in equity and not in the P/L.

The Court argued that Swiss tax and commercial law does not contain specific rules regarding the accounting treatment of FX translation differences, even though the latest version of the Swiss Manual of Accounting provides that they shall be

recorded in the P/L. However, the Court considered the Manual as a pure working guideline without binding legal effect. The court based its decision mainly on IAS 21 which includes rules for the translation of financial statements. According to IAS 21, all assets and liabilities are translated at the balance sheet rate (or historic rates where applicable), whereas the P/L is translated at exchange rates on the dates of the transactions (or the average rate, respectively). All resulting translation differences are recorded in equity.

## Comments

The Swiss Supreme Court distinguishes between translation differences and FX-gains and losses that arise in the functional currency (e.g. a company with USD functional currency is realizing a FX-loss on a EUR-denominated loan). The latter are considered as "real" FX-gains and losses and are still taxable or tax-deductible. On the other hand, translation differences are considered as pure accounting operations with no real commercial basis. Therefore such translation differences have no impact on the economic capacity of a company.

The decision of the Swiss Supreme Court confirms that a Swiss legal entity is entitled to use a functional currency other than CHF for its statutory accounts. On the other, the court decisions presents - depending on the interpretation of the wording - either a new standard for statutory accounting purposes that is also relevant for tax purposes or a departure from the decisiveness principle if the court decision is only applied for the tax declaration.

For the time being, the decision should be considered as binding for federal tax as well as Geneva cantonal / communal taxes. Based on informal information received, the Swiss Federal Tax Administration as well as the cantonal tax administrations are in discussions how to

apply the court decision on a consistent basis all over Switzerland.

The court decision itself does not provide any information with regard to transitional questions, in particular the treatment of translation differences in filed but not finally assessed tax returns. It appears that at least the canton of Geneva plans to apply the decision retroactively for all open tax periods. It is likely that other cantonal tax administrations will follow this approach.

## Actions

Swiss entities that keep their general ledgers in a foreign currency and that convert those into CHF statutory accounts should review their (tax) accounting approach with regard to the treatment of translation differences. If FX translation differences are recorded in the statutory P/L, such treatment should be reconsidered in light of the recent decision for purposes of the income tax declaration.

If a Swiss entity continues deducting FX translation losses for tax purposes, it should analyze whether it is necessary to record a tax contingency reserve, especially if the entity applies IFRS or US GAAP.

If an entity changes its approach with regard to the tax treatment of FX translation differences, it should also analyze whether the tax provision for all open tax periods needs to be amended. In addition, all tax filings for tax periods ending within the last 10 years that are finally assessed should be reviewed to make sure that FX translation differences were disclosed in the respective statutory accounts. Otherwise, there may be a risk that these tax periods will be re-opened and re-assessed. Furthermore, NOL carry forwards as well as tax rulings dealing with the FX-translation differences should be reviewed in light of the decision.

## Transitional “options” clause in the new Swiss VAT Law

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**The new Swiss VAT Law came into force as of January 1, 2010. Art. 114 of the new Swiss VAT Law features a transitional clause providing a number of options for taxable persons. These concern the tax liability (for businesses with turnover of less than CHF 100,000 in the 2009 calendar year that were still tax liable), group taxation, tax and reporting periods (quarterly, semiannual or monthly reporting), reporting methods (effective method, balance rate method or flat tax rate method) and form of reporting (reporting based on agreed or received consideration). These options may be applied by March 31, 2010, with retroactive effect to January 1, 2010. Two primary options for the taxable persons are briefly presented below as examples.**

### Group taxation

#### a) Principle

As under the old Swiss VAT Law, legal entities with their place of business or a permanent establishment in Switzerland, which are closely associated with one another under the common direction of a legal entity, may on application to the Swiss Federal Tax Administration (FTA) form a VAT group, i.e. combine as a single taxable person. Under the old Swiss VAT Law, a VAT group had to exist for a minimum of five years, whereas now derecognition of a VAT group may be declared at the end of a tax period. Under the new Swiss VAT Law, members of a VAT group can then be freely selected from among the eligible entities, and subgroups may now also be freely formed. In contrast to the old Swiss VAT Law, any natural person or legal entity can now also be elected as group representative. One may apply to the FTA by March 31, 2010, for the dissolution or recognition of a VAT group and for selection of a new group representative effective retroactively to January 1, 2010. Taxable persons that do not file with the FTA within the 90-day period are deemed to have retained their previously chosen status.

#### b) Rules for political units in particular

Agencies of political units may combine as a single taxable person under the new Swiss VAT Law. A group may be formed effective at the start of a given tax period, a choice that may not be changed until after at least one tax period. Here, too, one may apply to the FTA by March 31, 2010, for the recognition or dissolution of political unit's agencies as a group effective retroactively to January 1, 2010. If no such application is filed by March 31, 2010, it is deemed that the political unit agencies concerned have chosen to retain their previous status.

### Reporting using the flat tax rate method

Under the new Swiss VAT Law, taxable persons are still generally required to use the effective reporting method. Public entities, related organizations, non-profits and foundations may, however, elect the flat tax rate method.

Upon enactment of the new Swiss VAT Law, the lock-in periods for switching from the effective accounting method to the flat tax rate method and vice versa are also reset. In principle, switching from the flat tax rate method to the effective method is only possible after three years (previously: five years); a tax entity eligible to select the flat tax rate method, but which instead opted for the effective accounting method, may only switch to the flat tax rate method after ten years (previously: 15 years). There is currently controversy as to whether due to the tax rate increase effective January 1, 2011, the three and ten-year lock-in periods are to be shortened to one year on an exceptional basis for accounting method choices made as of January 1, 2010. In our opinion, Art. 115 Para. 1 of the new Swiss VAT Law clearly indicates that this is the case.

Under the new Swiss VAT Law, taxable entities that wish to switch from the effective to the flat tax rate method and vice versa may do so within 60 days of the start of a tax period from which a change is possible. However, during the transition to the new Swiss VAT Law the 90-day period supersedes the 60-day period, i.e. switching to or from the flat tax rate method retroactive to January 1, 2010, is possible by notifying the FTA in writing by March 31, 2010. If an option has not been chosen by that date, the legal assumption that the taxable entity wishes to continue using the previous accounting method applies.

# Mobility of workers in the EU - new European regulations regarding social security

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**As of May 1, 2010, a new European agreement on social security will enter into effect in the member states of the European Union. The provisions of Regulation n° 883/2004 are designed to standardize and modernize the provisions of Regulation n°1408/71, which has been in effect for almost 40 years.**

The date of enactment in Switzerland of this regulation remains uncertain, since these provisions must first be ratified by the Swiss Parliament. In the meantime, relations between Switzerland and the member states of the EU or EFTA will still be governed by the provisions of Regulation 1408/71.

## **General outline of the new regulation**

The basic principles of the existing Regulation 1408/71 remain the same, such as the uniqueness of the applicable legislation, the equality of treatment, the exportation of benefits and the cumulative addition of periods with insurance contributions.

However, the Regulation 883/2004 extends the scope of its application to cover pre-retirement regimes, amongst other new inclusions. It also extends its applicability to include all EU citizens who are, or who have been covered by social security in one of the member states.

The new regulation also puts an emphasis on increased communication between the institutions of member states, realized by the implementation of an electronic data exchange system. It should thus be possible to process secondment requests via the internet in the near future. Furthermore, it introduces the principle of good administration which obliges the institutions of member states to increase their mutual cooperation.

## **More specifically...**

### ▸ **Workers seconded to non-member countries**

Under the provisions of the present regulation, the initial duration of the posting which allows an employee to maintain his salary in the social security system of his country of origin is 12 months. The new regulation extends this period to 24 months. During this initial period, the agreement of the host country will not be requested, which should reduce the formalities associated with these procedures.

Otherwise, the maximum duration of a secondment remains 5 years.

### ▸ **Multiple activities**

Cases of multiple activities have caused and continue to cause practical difficulties. In fact, under Regulation 1408/71, if an employee normally performs his duties in several member states, including his country of residence, the total compensation received by the employee is subject to the social levies of the country of residence. This rule has a priori clearly created problems in application as each state has its own interpretation.

From now on, the new regulation makes the application of this rule subject to the exercise of a substantial part of the employee's activity in the country of residence, defined as greater than to 25% of the time at work and/or of remuneration.

Finally, the principle established by Regulation 1408/71 concerning persons simultaneously performing a salaried and non-salaried activity is confirmed, and exceptions have been eliminated. The entire remuneration obtained by this person will thus be assessable under the social security system of the country in which the salaried activity is performed.

### ▸ **Travelling personnel of international transport companies**

These employees are currently subject to specific provisions that will be eliminated by the new regulation. In the future, the general provisions of EU community law will apply. It is therefore essential that businesses employing personnel of this type are aware of the changes to come, since the situation of the concerned employees could change, generating a new risk for these employers in relation to social security.

## **The new regime: a new issue for employers?**

Although these proposals are designed to modernize and simplify the existing regime, it is not very likely that they will immediately achieve this objective. In fact, the existing provisions may remain applicable for a transitional period of 10 years.

This situation is therefore going to result in an additional administrative burden for the employers, who will have to track the employees subject to the provisions of Regulation 1408/71 and those subject to Regulation 883/2004 and will therefore have to juggle with these two regulations to manage their expatriate workforces.

In addition, employees with a certificate of secondment (E101) under the current regulation will be able to opt unilaterally for the application of the new regulation, which will not simplify the job of employers.

Finally, the reinforcement of exchanges between the institutions of various member states could increase the risk of visibility and control in social security matters.

# Mitigation of German loss trafficking rules

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**A strict loss trafficking rule has been in place concerning German corporations since the corporate tax reform in 2008. If between 25% and 50% of the shares in a loss-making corporation are acquired, existing losses forfeit on a pro-rata basis, whereas in the case of the purchase of a stake in excess of 50% existing losses forfeit totally.**

Above all during the current financial crisis, this regulation reveals its potential to further intensify the crisis, as even reorganization activities within a corporate group can result in the forfeiture of losses. The result is often that reorganization activities that make sense from a business point of view are not carried out. Moreover, attracting new investors also proves difficult. After all, if initial successes are registered after the restructuring measures have been introduced; the resultant tax payments immediately withdraw liquidity from the company in the difficult restructuring phase due to the lack of loss offsetting options.

The government has recognized the impact this has with regard to intensifying the crisis and has partially reduced this negative impact through the following measures implemented as a result of the Citizen Relief Act (Bürgerentlastungsgesetz) and the Growth Acceleration Act (Wachstumsbeschleunigungsgesetz).

## **Introduction of a restructuring clause**

Through the Citizen Relief Act, a restructuring clause was introduced that was initially applicable to shareholdings acquired in 2008 or 2009. The Growth Acceleration Act repealed the time limit, such that the restructuring clause now has unlimited validity.

The application of the restructuring clause is subject to the acquisition of a shareholding or a capital increase for restructuring purposes. Restructuring is defined as a measure that is implemented with the intention of preventing or eliminating insolvency or excessive indebtedness while simultaneously retaining key corporate structures.

Imminent insolvency is considered to be the case if the company is unlikely to be able to meet its existing payment obligations by the respective due date. Excessive indebtedness is considered to be the case if the company's assets no longer cover its existing liabilities, unless the continuation of the company is deemed likely.

The retention of key corporate structures can be achieved if a company agreement with employment regulation measures is observed or total wages do not fall below 400% of the initial level within five years of the acquisition of the shareholding or the company experiences a significant influx of new operating assets in the form of deposits within 12 months of the acquisition of the shareholding.

Furthermore, only companies that are capable of being restructured and whose measures are suitable for restructuring purposes can benefit from the restructuring clause.

## **Group clause**

In order to reduce the obstacles in group reorganization activities, a group clause was introduced via the Growth Acceleration Act that can be used for the first time for shareholding acquisitions occurring after 12/31/2009. Accordingly, losses do not forfeit if the same person has a 100% direct or indirect stake in both the legal entity being acquired and the legal entity acquiring the other. The group clause therefore does not apply in cases

in which the reorganization involves new shareholders joining the group or where non-group shareholders are involved.

## **Losses equating to the level of the available built-in gains do not forfeit**

In the case of a detrimental acquisition of a shareholding for which neither the restructuring clause nor the group clause applies, the existing losses can be retained to an amount equivalent to the level of company's built-in gains. This applies exclusively to the built-in gains subject to tax in Germany. The built-in gains, e.g. from shareholdings in subsidiary corporations, are not to be taken into account as profits from the sale of corporations are tax exempt.

In the case of an imminent proportionate forfeiture of losses, built-in gains taxable in Germany are taken into account on a pro rata basis, whereas in the case of an imminent full forfeiture of losses they are taken into account in full. Only those operating assets are to be taken into account in the determination of built-in gains as are attributable to the corporation at the time of the given transfer. Increases in built-in gains resulting from retroactive reorganizations are therefore not taken into account.

## **Opportunities and risks in the changes**

The changes are to be welcomed and show that the government has recognized that the loss limitation in its previous form overshoots the mark. The changes provide an opportunity for such reorganization activities to be carried out as make sense from a business management point of view and which may even be urgently necessary without losses being forfeited. However, there is still considerable uncertainty surrounding the changes at the moment, such that a detailed analysis should be carried out prior to any planned reorganization.

# Financing US Operations

## IRS' ability to re-characterize debt as equity increases risks for Swiss Multinationals with US subsidiaries

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**Swiss Multinationals with US operations often use a combination of debt and equity to finance their US operations. The benefit of debt is the interest on such debt is, generally, deductible for US federal income tax purposes and there is no withholding tax on the interest paid to the Swiss corporate parent under the US-CH Double Tax Agreement ("DTA"). A dividend however is not deductible and incurs a withholding tax of 5-15% under the DTA. However, the IRS has several tools to either deny, adjust the interest deduction or more severely re-characterize the interest deduction as a dividend thereby denying the deduction and subjecting the deemed dividends to withholding tax and applying interest and penalties on the increase in tax due to the adjustment.**

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### Three Methods of IRS Attack of Related Party Cross-Border Debt Financing

- 1 Transfer Pricing: If the rate of interest charged is not at "arm's length" as provided under US Transfer Pricing law, the IRS may adjust the interest to reflect an arm's length rate and thereby deny the interest deductions which do not represent the arm's length amount. However, if the interest charged is either consistent with the IRS' definition of arm's rate and supported by contemporaneous documentation or it meets the safe harbor rate as provided under US Treasury Regulations then generally the IRS will not adjust the interest rate based on transfer pricing principles.
- 2 Earnings Stripping Rules: Very generally US earnings stripping rules denies a US corporation's deduction for interest on obligations held by related persons if the US corporation's debt to equity ratio exceeds 1.5 to 1, and its interest expense exceeds fifty percent of a modified taxable income figure (very generally EBIDTA).
- 3 Substance of the Debt is Equity: Under US law and jurisprudence, the IRS may re-characterize debt as equity which consequently denies the interest deduction and re-characterizes such interest as dividends which may be subject to withholding tax.

### Analysis

If a US corporation either has a defensible transfer pricing study in place or the interest charged is within the safe harbor rates the IRS may have difficulty attacking the interest from a transfer pricing angle. Similarly, if the US corporation complies with the statutory rules surrounding the earnings stripping rules, the IRS may also have limited success. However, because the third test is a facts and circumstances test, the IRS is more likely to utilize this method.

A seminal US court decision provided 13 factors to be examined in determining whether an instrument is debt or equity. They are as follows:

- 1 the names given to the certificates evidencing the indebtedness;
- 2 the presence or absence of a fixed maturity date;
- 3 the source of payments;
- 4 the right to enforce payment of principal and interest;
- 5 participation in management flowing as a result;
- 6 the status of the contribution in relation to regular corporate creditors;
- 7 the intent of the parties to create a debtor-creditor relationship;
- 8 the identity of interest between creditor and stockholder;
- 9 the source of interest payments;
- 10 whether the debtor repaid the funds by the due date;
- 11 the extent the advance was used to acquire capital assets;
- 12 "thin" or inadequate capitalization; and
- 13 the ability of the corporation to obtain loans from outside lenders.

The jurisprudence in these factors is complex and often inconsistent, making

it impossible to determine with certainty whether an instrument will be characterized as debt or as equity for federal income tax purposes. Some courts have placed more weight on certain factors than on others, and not all factors have been considered by every court in analyzing a debt-equity characterization issue. However, courts have been consistent in finding that no particular factor is conclusive in making such a determination. Therefore, every factor should be considered when analyzing a particular fact situation and not limiting an analysis to one factor or a perceived acceptable ratio such as debt to equity or the more currently accepted ratio of debt to EBIDTA or the acceptable interest cover in the relevant industry.

### **Implications**

An IRS audit of a US corporation with a foreign parent is very likely to analyze the deductibility of cross border debt for US

federal income tax purposes. Included in this analysis is almost certain to bring an IDR ("Information Document Request") from the IRS requesting contemporaneous documentation to support the cross border debt financing consistent with the 13 factors listed above. Failure to provide such documentation, insufficient documentation and/or inadequate support of the debt position may result in the loss of interest deductions, the imposition of dividend withholding tax and penalties and interest which can be material.

### **Recommended Analysis**

Work closely with your US tax advisor to make sure the debt financing of your US operations is (a) consistent with US transfer pricing rules; (b) compliant with US earnings stripping law; and (c) consistent with the jurisprudence supporting debt and hence defensible from being re-characterized as equity.

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### **Imprint**

#### **Tax News**

Electronic publication in German, French and English

#### **Produced and designed by**

Ernst & Young Ltd  
Marketing and External Communications  
P.O. Box  
8022 Zurich

#### **Subscriptions / address changes**

[www.ey.com/ch/newsletter](http://www.ey.com/ch/newsletter)

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