

NEWSLETTER

March 2008

SCHELLENBERG WITTMER

Attorneys-at-Law

Second Corporate Tax Reform Act – Main features and expected results

In view of enhancing its attractiveness, in particular from a tax standpoint, Switzerland has undertaken its second important tax reform, which follows the first one which took place in 1997. Whereas the first reform enhanced Switzerland's attractiveness for holding structures, the modifications which were approved during the federal poll of February 24, 2008 aim at improving the situation of investors and of businesses, in particular those organized as partnerships. Part of the innovation resulting from the reform will already enter into force on January 1st, 2009. The other ones are likely to be effective as of January 1st, 2011.

1 The present situation

1.1 First corporate tax reform

The first milestone in improving Switzerland's attractiveness from an economical standpoint, which entered into force in 1998, simplified the computation of the tax burden on companies.

As a consequence, the Confederation (i.e. the Central State) as well as the majority of the Cantons adopted a flat rate on profit (the federal direct tax rate being 8.5%) for corporate entities. The flat rate's advantage is to enable – and to anticipate – an easy computation of the tax burden. It also no longer ties the tax rate with the amount of profits or with the productivity.

Besides, the first reform extended the application of the so-called participation exemption (also known as "holding privilege") to gains deriving from the sale of investments in other companies. The purpose of this mechanism is to reduce (if not eliminate) the triple or multiple economic taxation of profits distributed by a subsidiary as dividend to its parent company.

This extension of the participation exemption, which has been adopted by all Cantons, has definitively been an incentive for

Switzerland's attractiveness in terms of incorporating new companies, in particular holding ones.

Eventually, this reform eliminated, at the federal tax level, the taxation of equity (tax on capital) for corporate entities. As a matter of fact, the reason behind this tax was to correct the effects of the degression of the tax rate on profit in proportion to a company's equity (the higher the equity, the lower the rate on profit).

However, the tax on equity has remained compulsory at the cantonal tax level.

1.2 Points left opened after the first reform

Whereas it is clear that the progress made with the first corporate tax reform increased Switzerland's attractiveness for holding companies, other measures needed to be adopted in order to improve the overall conditions for investing in the Swiss economy and thus for creating employment. The second corporate tax reform contains the brunt of these measures.

2 Key points of the second corporate tax reform at the federal and cantonal levels

2.1 Reduction of the "double economic tax burden" at the individual shareholder's level

The double economic tax burden consists in the taxation of a corporate entity's profits, first at the company's level itself upon realization (tax on profit) and then as a shareholder's income upon distribution as dividend. This rule was fully applicable in Switzerland – at least at the federal tax level – until now.

The overall tax burden resulting from this concept could reach 60% of the profit before taxes of a given business, without taking into consideration the double taxation of the equity by taxing the capital on one hand and the shareholder's wealth on the other.



A reduction of this double economic tax burden was considered necessary for favouring investments in businesses. This alleviation takes the form of a reduction of the shareholder's tax basis, rather than of a reduction of the corporate (or individual) tax rate.

As a consequence, dividends resulting from investments of more than 10% (so-called qualified investments) will only be partially taxed, at least for federal direct tax purposes.

This reduction of the tax burden also applies to capital gains resulting from the sale of investments (10% or more) which belong to an individual shareholder's so-called commercial wealth, provided that there have been held for at least one year.

Having said that, one has to keep in mind that capital gains on shares belonging to an individual taxpayer's so-called private wealth, will continue to be exempt from income tax in Switzerland.

2.1.1 Federal direct tax

At the federal direct tax level, the taxation of qualified dividends will only apply to 60% of the said income, if the investment (i.e. the shares) belongs to the shareholder's private wealth, and to 50% if the investment is part of his commercial wealth. Similarly, this reduction will also apply to capital gains realized on investments belonging to an individual shareholder's commercial wealth.

2.1.2 Cantonal and municipal taxes

The above development in the federal direct tax, which should allow a readjustment in business financing, between debt and equity, could be followed at the cantonal and municipal levels.

In fact, in addition to the Federal Direct Tax Act, the Federal Harmonization Act for cantonal and municipal Direct Taxes now enables Cantons and municipalities to reduce the taxation of dividends received by individuals. In reality, many Swiss German Cantons as well as the Canton of Valais anticipated this possibility. It is very likely that the French speaking Cantons will also follow this path, be it only for tax attractiveness reasons.

2.2 Reduction of the double economic tax burden for corporate investors

In addition to the above measures in favour of individual investors, the second corporate tax reform extends the participation exemption, which applies to investors organized as corporate entities.

2.2.1 Participation exemption – federal direct tax

The conditions under which a corporate entity (company limited by shares or cooperative company) can benefit from the participation exemption – whose objective is to reduce if not eliminate the multiple economic tax burden – have been relaxed. Thus, dividend income or capital gains resulting from investments will benefit from the participation exemption as

soon as the investments are of at least 10% (20% until now) or that they have a value of at least CHF 1 million (CHF 2 million in the past). This exemption will be also granted when the beneficiary company is entitled to at least 10% of the profits and of the retained earnings from the distributing company.

The conditions under which the participation exemption applies to capital gains realized on the sale of investments are also extended to investments of at least 10% (20% until now) or to an entitlement of at least 10% of the profits and retained earnings from the distributing company.

2.2.2 Participation exemption – cantonal and municipal taxes

With respect to the taxation of dividend income resulting from investments, the new conditions are directly applicable at cantonal and municipal tax levels.

However, with respect to the taxation of capital gains deriving from the sale of investments, the Cantons are free to decide whether to apply the participation exemption and its new conditions.

2.3 Reduction of the tax burden on a business' substance

The reform contains three specific measures, aimed at reducing the tax burden on a business' substance, both at direct and indirect tax levels.

2.3.1 Reimbursement of the capital contribution (agio)

In parallel to the reduction of the double economic tax burden, the Swiss legislator intends to exonerate the reimbursement of additional payments made by a shareholder (known as agio).

Contrary to the present system, the distribution to an individual shareholder (whose shares belong to his private wealth) of reserves consisting of his previous capital contribution will no longer be subject to income tax.

This measure, which is directly applicable at federal, cantonal and municipal direct tax levels as well as for federal withholding tax purposes, puts an end to an undue taxation of investments into a business made by the shareholder himself when such amounts were returned to him.

However, this exoneration only applies to capital contributions made after 1996 and clearly identified as such in the company's balance sheet. Further, this exoneration should not apply to agio booked at a company's level in view of eliminating the so-called transposition risk occurring during previous share contributions made by a shareholder to the company.

2.3.2 Charging of the tax on profits to the tax on equity

The taxation of equity of companies organized as companies limited by shares or cooperative companies remains a peculiarity of the Swiss tax system, despite its abolition in 1998 at the federal level further to the first corporate tax reform.

Indeed, the tax on equity is unknown to the majority of countries. It further represents a cost factor, although variable, that has an effect on the profits before taxation. In other words, a company's financial situation before the tax on profits can only be positive after all expenses have been covered, including the tax on equity.

Without eliminating this taxation, the second corporate tax reform enables the Cantons to reduce its effects by authorizing the charging of the tax on profits to the tax on equity.

In practice, this means that, as soon as the tax on profits will be equal or higher to the tax on equity, the latter will no longer be due. This also means that the tax on equity will play the role of a minimum tax, which will give way to the tax on profits as soon as this one is higher. In other words, the tax on equity will only remain for loss making companies.

Nevertheless, it is clear that this measure will represent a noticeable alleviation of the tax burden for profitable companies. It will also offer a better integration in terms of tax consolidation.

2.3.3 Evolution of the exemptions for federal issuance stamp duty

The first specific measure harmonizes the level of exemptions between corporative companies and companies limited by shares upon the creation or increase in value of participation rights (share capital for companies limited by shares). The new unified exemption is now of CHF 1 million.

In addition, two measures were adopted for companies which face financial reorganization. The first measure exonerates the creation or increase in nominal value of participation rights (shares) aimed at taking over all or part of the operations of an over-indebted company. The second measure exonerates the creation or increase of participation rights in the scope of a so-called open financial reorganization (i.e. when a company's share capital is reduced and then increased again), provided that the existing losses are eliminated and that the amounts contributed are not higher than CHF 10 million in total.

2.4 Alleviations in favour of partnerships

The main measures in favour of partnerships relate to the transfer of a business, to the taxation upon termination and to the renewal of investments.

2.4.1 Extension of the concept of reinvestment

The renewal of the producing assets, which is also required in case the business' activity is reoriented, usually requires the sale of an asset and the purchase of another.

In order not to unnecessarily burden the realized hidden reserves when they are reinvested in the business, the concept of reinvestment allows to carry over these hidden reserves onto the new asset. The reform extends the possibility of such carry-over, because the sole remaining condition is that the asset sold and purchased be a fixed asset. In the past, it was

further required that the new asset served the same function as the old one, which is no longer necessary.

2.4.2 Valuation of securities belonging to a shareholder's commercial wealth

Regarding the taxation of an individual taxpayer's commercial wealth, the reform establishes the primacy of the book value over the fair market value, including for investments (which were previously taxable at their fair market value).

This measure, which does not apply to real estate, intends first to reduce the taxation of the commercial wealth and, second, to alleviate the administrative work required for determining the taxable value of such wealth.

2.4.3 Postponed taxation in the event of real estate transfers from the commercial wealth to the private wealth as well as in the event of rental

When an asset is transferred from an individual taxpayer's commercial wealth to his private wealth, which is an operation without cash transfer, the tax system considers that the hidden reserves related to this asset are deemed realized and thus subject to the income tax. This situation is typical for real estate which is no longer or only to a limited extent operated for commercial purposes - thus usually upon termination of a business activity.

In order not to levy taxes on the hidden reserves before their effective realization - i.e. before the taxpayer actually disposes of the cash necessary for settling the tax -, the taxation will occur, upon the taxpayer's request, only after the effective sale of the real estate.

Similarly, in the event that the business activity is rented out, which applies primarily to the farming sector, taxation of the asset transfer from the commercial wealth to private wealth can be postponed upon the taxpayer's request.

2.4.4 Measures concerning the transfer of businesses by way of succession

Upon the transfer of a business by way of succession, there might be a doubling-up of inheritance tax and income tax, when all or part of the heirs do not take over the business operation (partial realization of hidden reserves in the hands of the heirs who do not continue the business). This situation implies a transfer of business and leads to the realization of hidden reserves in terms of income tax.

This problem, which penalized the taking-over of a business, is now eliminated, in order to further business continuity. Thus, the taxation of hidden reserves will, from now on, be postponed upon their actual realization, meaning until the sale of the related assets.

2.4.5 Relief of liquidation proceeds

When an individual who owned a business sold the latter upon terminating his activity, the resulting liquidation profits



were taxed as ordinary income, i.e. together with his other taxable income. This could lead to a marginal rate of up to 50% (including social security contributions), although the hidden reserves were built up over all the years of his business activity.

The second corporate tax reform introduces a significant reduction of this tax burden, when the seller is 55 years old or more and provided that he permanently terminates his activity. In such an event, the liquidation profits will, from now on, be taxed separately from any other income and at a reduced rate – which reduces the income tax's progressivity.

Moreover, private pension schemes set up by the seller will be better taken into consideration when assessing this tax. Accordingly, amounts contributed to private pension funds will henceforth be deducted from the profits deriving from the sale of a business. The remaining part will be subject to a separate taxation at a reduced rate (minimum 2% for the federal direct tax). Moreover, if such pension contributions were not actually made but their admissibility is evidenced, and in the event of a lack of pension coverage, the part of the profits corresponding to this lack will be taxed in the same manner as a pension fund payment, meaning separately and at a reduced rate (one fifth of the ordinary rate for the federal direct tax).

The principle of this tax treatment is compulsory for the Cantons, which remain free to determine their own (reduced) rates for the cantonal and municipal tax purposes.

2.5 Open question: the quasi-professional securities dealing

The concept of quasi-professional securities dealing belongs to the recurrent themes of the Swiss tax system, which is based on a (sometimes precarious) balance between exonerating private capital gains and fully taxing such gains (including social security contributions) when they derive from an activity deemed professional.

The difference is not academic: in the first case profits are not subject to income tax (and the losses are not deductible); whereas in the second case profits are subject to the global tax rate (federal, cantonal and municipal direct taxes and social security contributions) that can exceed 50% and losses are deductible.

This issue, which the legislator has tried to regulate for clarity and legal security purposes for a number of years, in particular since the 1998 financial stabilization program, was part of the drafts of the second tax reform act. In the end, it was decided not to handle this issue in this frame. Thus, uncertainties in this area remain for the time being.

3 Entering into force and cantonal developments

The entry into force of the second corporate tax reform will be gradual and will require, at cantonal levels, additional legislative work.

The reduced taxation of dividends received by individual investors, as well as capital gains realized or investments belonging to the commercial wealth, should enter into force in 2009 at the federal tax level, while the other measures will enter into force two years later, i.e. in 2011.

On the cantonal and municipal levels, the compulsory measures will enter into force in 2011. As for the optional measures – which are reducing the taxation on dividends for individual shareholders (for the Cantons where it is not yet the case), extending the participation exemption for corporate entities, charging the tax on profits to the tax on capital as well as defining the tax rates for liquidation profits upon the sale of a business activity –, each Canton will act individually and will decide to use or not the discretion granted by the federal legislation.

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