What's Going On In...

Switzerland

Business Tax Reform 1997

By Peter Reinarz*

On 10 October 1997 the Swiss Parliament passed the Federal Act on the Reform of Business Taxation 1997. The reform is designed to improve the tax environment for business in Switzerland and to enhance Switzerland's attractiveness as a location for international companies. It is expected, however, that the reform package will result in a net decrease in annual tax revenues of approximately CHF 170 million per year.

The Reform Act is still subject to a non-obligatory popular referendum; there is, however, a fair chance that no referendum will have to be held. In that case, the federal government intends to enact the Reform Act as of 1 January 1998.

TAX REFORM PACKAGE

The reform package as passed by the federal parliament consists of five different parts:
- a reform of the tax treatment of participation and holding companies, in particular, extension of the "participation exemption" system to capital gains on substantial participations (so far, the "participation exemption" covered dividend income only);
- introduction of a flat corporate income tax rate of 8.5% to replace the equity-dependent, progressive income tax rate; abolition of the corporate capital tax;
- reduction of the stamp duty on the issue of shares and similar participation rights from 2% to 1%;
- statutory regulation of the tax consequences of the acquisition of treasury stock; and
- re-introduction of a 2.5% federal stamp duty on one-time premiums for life insurance.

EXTENSION OF THE PARTICIPATION EXEMPTION

Under the present law, corporations and cooperatives that hold substantial interests in participations in the capital of other corporate entities are entitled to a "participation exemption", i.e. a proportional reduction of the income tax in respect of dividend income received from such participations. Participations include shares in joint-stock companies, limited liability companies, participation certificates in such entities and similar corporate participation rights. A participation is substantial if it represents at least 20% of the share capital of another company. Alternatively, the substantiality test can also be met if a participation of less than 20% has a fair market value of at least CHF 2 million.

The proportional reduction of the ordinary corporate income tax is calculated on the basis of the ratio between the "net participation income" and the company's total taxable net income. The "net participation income" corresponds to the gross *dividend* income from qualifying participations, reduced by non-refundable foreign withholding taxes, 5% of the gross participation income for administrative costs, interest and similar financing costs attributable to the participations, and any depreciation of participations in connection with a dividend.

Capital gains (alienation gains, book gains from revaluations) on participations are not covered by the participation exemption system under present law. Under the Reform Act, however, capital gains on participations and proceeds from the sale of subscription rights attached to participations will qualify for the participation exemption. Mere book gains (appreciation gains) will, however, remain excluded from the participation exemption system.

Capital gains on participations and proceeds from the sale of subscription rights qualify for the participation exemption only if the following *conditions* are met:
- the participation sold must represent at least 20% of the other company's capital; the alternative criterion of a CHF 2 million fair market value does not apply to capital gains;
- the participation must have been held for at least one year (the minimum holding period does not apply to dividends from participations);
- the capital gain qualifies for the participation exemption only to the extent that the sales proceeds exceed the cost value of the participation. Any gain portion representing recaptured depreciation does not qualify; and
- the transaction giving rise to the capital gain must not fall under the new anti-avoidance rule of Article 70(5) Federal Direct Tax Law (FDTL). According to this new provision, any transactions that would cause unjustified tax savings within a group of companies are subject to either an adjustment of the taxable net income or a limitation of the participation exemption. According to the statutory definition, unjustified tax savings are achieved if there is a causal nexus between capital gains and capital losses or depreciation of participations. Moreover, value adjustments and depreciation of participations representing at least 20% of another company's capital will be added back to the company's taxable income as soon as such valuation reserves or depreciation are no longer justified.

The Reform Act contains restrictive *transitional rules for "old participations"*. Old participations are those which were held by the taxpayer before 1 January 1997. Capital

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gains realized on old participations before 1 January 2007 remain taxable under the provisions of the previous law. Capital gains realized on old participations on or after 1 January 2007 will, however, qualify for the participation exemption. For capital gains tax purposes, the value of an old participation is defined as the taxpayer's income tax basis in such participation as of the first day of the business year ending during the calendar year 1997.

Article 207a (3) FDTL contains a special *transitional rule for cross-border transfers of participations within a group of companies*. Any capital gain on at least 20% participations that were already owned by the corporate taxpayer before 1 January 1997 and which are transferred to a foreign company belonging to the same group before 1 January 2007 must be included in the taxpayer's taxable net income; the gain is calculated as the difference between the income tax basis and the fair market value of the participation. However, the income inclusion of the gain is neutralized and the gain is effectively deferred since the taxpayer is entitled to charge a tax-free reserve in the amount of the gain to the profit and loss account for tax purposes. The tax-free reserve must be tax-effectively released as soon as the participation transferred to the foreign group entity is sold by such an entity to a third party outside the group, or if the company whose shares were transferred disposes of its assets and liabilities to a substantial degree ("factual liquidation"), or if such an entity is formally liquidated. Any existing tax-free participation reserves will be released by 31 December 2006 with no tax consequences. Until that date, the corporation must attach to each tax return a list of all old participations transferred to foreign group companies for which it has built a tax-free reserve.

As far as *cantonal and communal taxes* are concerned, the cantons are entitled under Article 28(1 bis) of the Federal Tax Harmonization Law (FTHL) to extend the participation exemption provided in the cantonal laws to capital gains on participations and sales proceeds from subscription rights.

INTRODUCTION OF A FLAT 8.5% CORPORATE INCOME TAX; ABOLITION OF CAPITAL TAX

Under the existing Federal Tax Law, corporations and cooperatives pay federal income tax at progressive rates ranging from 3.63% to a maximum of 9.8%. The maximum tax rate applies if the ratio between the taxable net income and the company's net equity exceeds 23.15%. Furthermore, under the existing law, corporations and cooperatives are subject to an annual 0.08% federal capital tax on their net equity, consisting of the paid-up share capital, contributed surplus (if any) and all other open reserves and retained earnings, as well as those hidden reserves that have been taxed as income.

Under the Reform Act, the progressive income tax rate is replaced by a flat corporate income tax rate of 8.5%. Moreover, the federal capital tax is abolished. Corporations and cooperatives will, however, continue to have to report their net equity on an annual basis. To the extent a portion of a company's debt is re-characterized as "hidden equity", any interest paid thereon is added back to the taxable income.

RELIEF ON THE FEDERAL STAMP DUTY

Under current law, any contribution of cash or other assets to the capital of a joint-stock corporation, limited liability company or cooperative corporation incorporated under Swiss law, whether or not in exchange for an issue of shares, participations or similar equity securities, is subject to a federal stamp duty of 2% of the net amount of the capital contribution. In the case of a contribution of non-cash assets, the tax is payable on the fair market value. Exemptions apply to a number of transactions such as:

- the initial contribution to the capital of the corporate entity incorporated in Switzerland in connection with its formation if the net amount of the contribution does not exceed CHF 250,000;
- share issues in connection with transactions which qualify, for stamp duty purposes, as corporate reorganizations (mergers of corporate entities, merger-like transactions, spin-offs, certain corporate transformations); and
- share issues in connection with the transfer of the corporate domicile of a foreign corporation, which originally was incorporated abroad, to Switzerland if the foreign law does not require a formal liquidation of the emigrating corporation.

Under the Reform Act, the stamp duty rate is reduced from 2% to *1%*. Furthermore, the exemption applicable to small corporate entities with a capital not exceeding CHF 250,000 (including share premium, if any) now constitutes a general tax-free allowance, which applies not only to the initial capital contribution upon the formation of the company, but also to any capital increase under the threshold. For example, if a company is formed with an initial capital of CHF 100,000 and the capital is later increased to CHF 300,000, CHF 50,000 of the capital increase is subject to 1% stamp duty.

LIBERALIZATION OF THE TAX REGIME FOR TREASURY STOCK

Joint-stock corporations may acquire up to 10% of their own shares, provided that they have enough freely distributable retained earnings to cover the repurchase of shares. The maximum limit for the acquisition for a corporation's own shares (treasury stock) is increased to 20% if the acquisition is in connection with a transfer restriction on registered shares. Any shares acquired in excess of the 10% must either be resold within two years or must be cancelled by way of a share capital reduction (see Article 659 Code of Obligations (CO)). To date, the federal tax laws have not contained any rules on the tax treatment of the acquisition of treasury stock. According to the practice of the Federal Tax Administration, any acquisition of treasury stock will generally be treated as a *partial liquidation* of the company.

However, the tax consequences of a partial liquidation are not imposed if the corporation resells the redeemed own

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stock within a two-year term; furthermore, the tax consequences of a partial liquidation are not imposed in the case of treasury stock redemption by companies whose shares are listed on a stock exchange and which purchase and sell own shares on a regular basis, provided that the company can prove a bona fide trading activity in treasury stock on the basis of the notes attached to its annual financial statements. The treatment of a stock redemption as a partial liquidation gives rise to federal income taxation at the level of the private seller of the shares for the difference between the stock redemption price and the face value of the shares. The same amount is subject to the federal withholding tax at the rate of 35%; the withholding tax is owed by the corporation making the stock redemption; the corporation is legally obliged to pass the burden of the withholding tax on to its (former) shareholder. The Reform Act makes a distinction between stock redemptions in consideration of a shareholders' resolution for a share capital reduction (or in view of a planned capital reduction) and stock redemptions without any subsequent capital reduction. Stock redemptions in connection with a capital reduction are generally treated as partial liquidations. Furthermore, the same tax consequences will occur if the acquisition of own shares by the corporation exceeds the limits set by Article 659 CO. A new regime applies to stock redemptions without a subsequent reduction of the share capital. The federal withholding tax will be levied if the corporation holds own shares that it has redeemed from a shareholder within the limits set by Article 659 CO for a period of more than *six years*. The withholding tax becomes due on the date of the expiry of the permissible holding period. On the same date, taxable investment income is deemed to have been realized for federal income tax purposes. Furthermore, the six-year deadline for the resale of the treasury stock will not start to run if the corporation has acquired its own stock in order to cover obligations arising from a convertible bond, a bond combined with stock options or an employee stock participation plan. In these cases the deadline for the resale of the treasury stock will start running only when the respective obligations have expired. However, in the case of employee stock participation plans, the standstill period for the deadline is limited to a maximum of six years. The Reform Act will also apply to transactions completed prior to the date of enactment of the Reform Act, unless the tax is already finally assessed or the tax claim has expired due to the statute of limitations.

REINTRODUCTION OF 2.5% FEDERAL STAMP DUTY ON ONE-TIME LIFE INSURANCE PREMIUMS

Under current law, premiums paid for domestic insurance policies to Swiss or foreign insurance companies are subject to a federal stamp duty of 5%. However, certain types of insurance premiums, including all life insurance premiums, are exempt from the stamp duty. As a partial compensation for the tax revenue losses caused by the above tax reform measures, the parliament has decided to reintroduce a 2.5% federal stamp duty on one-time premiums paid for redeemable life insurance policies. However, redeemable life insurance policies with periodic premiums remain exempt from the stamp duty. Moreover, premiums for life insurance policies within the scope of the Federal Act on Occupational Pension Plans remain exempt, as well as all life insurance premiums (whether one-time or periodic) paid by non-Swiss resident insured persons.

FURTHER CHANGES

Tax treatment of domiciliary, auxiliary and administrative companies

Under the FTHL, the cantons have to grant privileged cantonal and communal income tax treatment to "domiciliary", "auxiliary" or "administrative" companies. The privilege for these types of company consists of a full exemption from tax of dividend income and gains from substantial participations, as well as a partial exemption of all foreign-source income. Swiss-source income is ordinarily taxed. Under current law, the tax privilege excludes any "genuine" business activities performed in Switzerland, whereas activities of a mere "auxiliary" or administrative character are permitted. No restrictions apply in respect of business activities performed abroad.

The Reform Act now extends the tax privilege as well to those companies whose business activities are predominantly foreign-related if they also perform "genuine" business activities in Switzerland. The wording of the revised provisions indicates that the business activities conducted abroad must outweigh those conducted domestically. This liberalized requirement in fact reflects the current practice of various cantons under their local laws. It allows international companies (whether Swiss or foreign-controlled) to locate "true" business functions (e.g. trading) in Switzerland without necessarily jeopardizing the cantonal tax privilege available to companies that mainly do business abroad and/or earn income from foreign sources.

Treatment of losses through foreign permanent establishments

Switzerland unilaterally applies the exemption method for profits of a Swiss company derived through a permanent establishment located abroad. Under current Swiss tax law, a Swiss corporation may principally set-off losses derived through a foreign establishment against domestic profits. However, if the foreign permanent establishment makes any profits during the seven years following the loss year, the Swiss tax assessment could subsequently be reopened and the previous foreign losses would only be taken into account for income tax rate determination purposes. The set-off of foreign permanent establishment losses against domestic profits is limited under the revised version of Article 53(3) FDTL. Foreign losses will only be taken into account to the extent such losses could not be deducted for income tax purposes in the foreign country where the permanent establishment is located. If the foreign permanent establishment makes any profits during the seven business years following the loss year, such profits will be subject to taxation in Switzerland to the

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extent those foreign profits could be set off against accumulated tax losses in the country where permanent establishment is located.

TAX TREATMENT OF PERMANENT ESTABLISHMENTS OF FOREIGN COMPANIES

Corporate entities having their seat and the place of their effective management outside Switzerland that are engaged in business activities in Switzerland through a permanent establishment must pay Swiss income tax on the net profit derived through the Swiss permanent establishment, regardless of whether or not the foreign company derives an overall net profit. A foreign company organized in a country which has a tax treaty with Switzerland and which is in an overall-loss position might challenge the application of such rule based on the anti-discrimination rule of the treaty.

INCREASE OF INCOME TAX RATE FOR ASSOCIATIONS, FOUNDATIONS AND OTHER LEGAL ENTITIES

The capital tax was abolished not only for corporations and cooperatives but also for foundations, associations and other legal entities. On the other hand, the flat income tax rate applicable to foundations, associations and other legal entities has been increased from 4% to 4.25%. Any net income below CHF 5,000 is not taxed.

United Kingdom

Consultative Document on Transfer Pricing

By Les Secular*

On 9 October 1997 the UK Government unveiled new plans to update its laws on transfer pricing. This new legislation is designed to protect the UK tax base in the modern world, following the significant growth in world trade. The Revenue believes the changes should promote voluntary compliance and fairness but also minimize compliance costs. The proposed legislation will oblige taxpayers to apply the arm's length principle to transactions with connected parties and thus make them feel secure in signing their self-assessment returns.

REPLACEMENT SECTION/SCHEDULE

Appendix 1 of the Consultative Document (hereinafter: Con Doc) contains three draft clauses and one schedule replacing Sections 770 to 773 TA 1988. New Section 770A refers to new Schedule 28AA, which contains all the relevant details. Certain Sections of Finance Acts are amended to replace references to S770 TA 1988 with references to Schedule 28AA. In particular, these are FA 1993 S136 (7), S136(8), S136A (5), S136A (6) (foreign exchange gains and losses), FA 1996 S100 (3) and Schedule 9 Paragraph 16 (loan relationships).

COMMENCEMENT DATE/APPOINTED DATE

The Appointed Date is still to be announced but is likely to be in early 1999. The new rules will apply to accounting periods ending on or after the Appointed Date. Consequently, accounting periods commencing in early 1998 could be within the new legislation.

ARTICLE 9 OECD MODEL

It is intended to reassert the arm's length principle by introducing into UK law the effect of Article 9(1) of the OECD Model Tax Convention (hereinafter: OECD Model). This article is headed "Associated Enterprises". In the past the Revenue has attempted to use Article 9 when unsuccessful under other articles, especially Article 11 (interest). They have also sought to impose a UK tax charge using Article 9 in conjunction with Section 788(3)(c) TA 1988 where deficiencies with the current transfer pricing law have prevented adjustment, but they have not been very successful with this approach.

Article 9 states that adjustments can be made to dealings between certain parties if one of those parties participates directly or indirectly in the management, control, or capital of the other (or other parties do so in both companies) and the terms and conditions between them are not at arm's length.

Indirect control is not defined, but as indicated below the Revenue has attempted to define it in a wide manner for the purposes of the new legislation.

DETERMINATIONS/NOTICES

New Section 30C TMA 1970 sets out the requirements for determinations requiring the sanction of the Board of Inland Revenue. Essentially there are three occasions when such a determination is required:

- the giving of a notice under S28A (5) or S28B (5) TMA 1970 (completion of enquiries into a self-assessment return or partnership statement requiring an amendment thereto);
- the making of an assessment under S29 TMA 1970 (assessment where loss of tax discovered); and
- the giving of a notice under S30B (1) TMA 1970 (as inserted) (amending a partnership statement where loss of tax is discovered).

If the notice or assessment is given without the determination having been approved by the Board of Inland Revenue or without a copy of the Board of Inland Revenue's approval having been served, the notice, or assessment,

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