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Tax and the acquisition of a corporation's own shares in Switzerland

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On March 26 2002, the Swiss Federal Tax Administration (FTA) issued an Information Letter on a circular of the Swiss Bankers' Association (Circular 7023) providing some clarification on section 2.2 of the FTA Circular Letter No 5 dated August 19 1999 (Circular 5) "Business Tax Reform 1997 — the New Regime for the Acquisition of a Corporation's Own Shares".

Swiss income tax and withholding tax laws generally treat repurchases of own shares by a Swiss company as partial liquidations that give rise to personal income tax and withholding tax consequences. However, within certain limits, a company may redeem its own shares and hold them as treasury shares for a period of up to six years before the partial liquidation tax consequences arise. Finally, the law provides for a standstill of the six-year period whilst own shares are held to cover contingent equity obligations under a convertible bond, a bond combined with equity warrants (option bond) or an employee stock participation plan (ESOP) of the company.

Section 2.2 of Circular 5 and Circular 7023 deal with the details of the conditions for the standstill of the share resale deadlines provided under the withholding tax and income tax laws. The clarifications of Circular 7023 were worked out by the FTA after consultations with the Swiss Bankers' Association. Circular 5 requires an "original nexus" between the share repurchase and the contingent equity obligations under a convertible or option bond or an ESOP, for the resale deadline to stand still. Circular 7023 illustrates in more detail how the original nexus can be created and proven. The new practice is effective as of July 1 2000. While regulated banks had time until March 31 2001 to adapt to the new rules, any corporate issuers other than banks benefit from a transition period lasting until July 31 2002.

Legal background

Under Swiss law, joint stock corporations may acquire up to 10% of their own shares, provided that they have sufficient freely available retained earnings to cover the repurchase of shares. The own share acquisition threshold is exceptionally increased to 20% when registered shares are acquired in connection with a transfer restriction stated in the company articles. Any such shares legitimately acquired in excess of the 10% limit must either be resold within two years or must be cancelled by way of a share capital reduction (article 659 Code of Obligations).

In connection with the Business Tax Reform 1997, the tax treatment of the acquisition of treasury stock was for the first time specifically regulated in the federal tax laws. According to these federal tax rules, any acquisition of a company's own shares is generally treated as a partial liquidation of the company. The treatment 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 (nominal value) of the shares. The same amount is subject to the federal withholding tax at the rate of 35%. This holds true irrespective of the price at which the former shareholder had acquired the shares (nominal value principle). The withholding tax is technically a liability of the corporation making the stock redemption; however, the corporation is legally obliged to pass the burden of the withholding tax on to its (former) shareholder. However, the federal tax laws describe certain circumstances under which the tax consequences of a partial liquidation are not imposed.

Article 4a of the Withholding Tax Act draws 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. As a rule, stock redemptions in connection with a capital reduction generally trigger the tax consequences of a partial liquidation. Furthermore, the same tax consequences apply to any own shares acquired in excess of the limits set by article 659 Code of Obligations.

With regard to stock redemptions not made in view of a reduction of the share capital but rather for a holding as "treasury shares", the following principles apply: the federal withholding tax (and personal income tax where applicable) is levied when the corporation holds the repurchased own shares — within the limits set by article 659 Code of Obligations — for a period of more than six years. The taxes become due on the date of the expiry of the six-year holding period.

Furthermore, the six-year resale deadline for treasury stock stands still (or does not start to run), when the corporation

has acquired its own stock to cover obligations arising from a convertible bond, an option bond or an ESOP. In these cases the deadline for the share resale starts running (again) when the respective obligations have expired and the shares have not been used. In the case of an ESOP, the length of the standstill period of the resale deadline is also limited to a maximum of six years.

Section 2.2 of Circular 5 suggests that the withholding tax law requires the presence of an "original nexus" between the share repurchase and the contingent equity obligations under a convertible or option bond or an ESOP for the benefit of the deadline standstill to apply. Hence, the acquisition of the own shares must initially arise in view of existing equity contingencies and the benefit cannot be achieved by a simple redesignation of treasury shares after their acquisition by the company. Of course, the company carries the burden of proof for the original nexus.

The substance of Circular 7023 — interpretation of the "original nexus" requirement

Generally, the FTA recognizes an "original nexus" between a share redemption and a convertible bond, an option bond or an ESOP under the following cumulative conditions:

(a) Existence of the obligations at the time of the redemption of own shares — at the time of the share repurchase, the obligations arising from a convertible bond, an option bond or an ESOP must already exist, ie the shares are clearly repurchased in view of such existing obligations; and
(b) Entry in the books on a separate, labelled account — moreover, the own shares must be booked into a separate account, which must be reserved and designated for the respective convertible bond, option bond or ESOP.

Furthermore, the original nexus is also acknowledged by the FTA if the corporation acquires own shares in view of possible future issues of convertible bonds or option bonds (or ESOPs yet to be implemented). In that case, the conditions for the standstill of the six-year deadline for the resale of the shares are as follows:

(c) Booking of the own shares on a separate account — the own shares repurchased in view of future issues of convertible or option bonds (or, according to oral statements of the FTA, future ESOPs) must be booked into a separate "collective" account and a book entry must be made for each single transaction, indicating the number of shares and the date of their repurchase; and
(d) Exclusivity of the separate account — the separate, special account may exclusively be used for share repurchases in view of future convertible and option bond issues (or future ESOPs); disposals of own shares that are no longer needed to cover obligations under such bonds (or ESOPs) must be booked through the securities trading portfolio, and no other transactions may be booked through the special account.

In the last-mentioned scenario, the six-year deadline for the resale of the own shares starts running on the day of the share repurchase. However, provided that the company effectively issues a convertible or option bond (or implements an ESOP) before expiry of the resale deadline, then the treasury shares held may be transferred in one block from the collective account to a single special account which must be labelled to reflect the concrete convertible or option bond (or ESOP).

(e) The deadline for the share resale will stop running, provided that such transfer from the collective to the single labelled account occurs with the payment of the bond at the latest;
(f) The deadline stands still until all equity obligations under the convertible or option bond (or ESOP, with a maximum standstill period of six years) have expired.
(g) To the extent that the shares in the special, single account are not used to settle equity obligations under the bond or ESOP, the six-year resale deadline will continue running again from the date of expiry of the equity obligations; and
(h) Once the resale deadline has finally expired (taking into account the standstill period), any own shares still held by the company are deemed to be cancelled, and the withholding tax and personal income tax (where applicable) consequences of the "partial liquidation" are imposed.

It is not possible to create a multiple nexus for repurchased own shares. Hence, any remaining own shares after expiry of equity obligations under a convertible or option bond (or ESOP) must be booked out through the trading portfolio and cannot be re-transferred into the collective account for future convertible or option bond issues (or ESOPs).

Any transactions in own shares from the single, special account during the standstill period are limited to transactions for so-called "delta hedging". If, after the expiry of the equity obligations, any own shares are left over, such shares will again be subject to the resale deadlines of the treasury shares that were previously transferred in one block from the collective account into the single account. The first in, first out approach will be applied to such leftover shares, ie an amount of shares corresponding to the previous block transfer will have the corresponding remaining resale

deadlines as of the date of the block transfer into the single account and any additional shares acquired for the single account pursuant to the delta hedging will have a full six-year resale deadline.

The company cannot stop the six-year resale deadline when it first redeems own shares outside the framework described in the foregoing paragraphs (ie without immediately allocating the shares to either a collective or a single special account for a convertible or option bond or to an existing ESOP). In other words, any repurchased shares that are held as treasury shares and not immediately allocated to an existing ESOP or either directly to a single, labelled account for a convertible or option bond, or first to a collective account and thereafter, within the six-year period, to a single labelled account must, in each case, be resold within six years of the repurchase date, even if such shares are at some point after their repurchase put aside for a convertible or option bond or an ESOP — such subsequent treasury share allocations do not affect the running of the share resale deadlines. Likewise, the initial allocation of the treasury shares to a collective account has an effect on the six-year deadline only if the shares are transferred into a single, labelled account for a concrete convertible or option bond (or ESOP) within six years of the initial share repurchase.

Stamp duty aspects

Share repurchases by the company are subject to the ordinary transfer stamp duty regime. If the company itself, the counterparty or an intermediary in the transaction is a securities dealer as defined in the Stamp Duty Act (eg a financial institution or a company which holds taxable securities — shares, bonds, notes etc — in excess of SFr10 million), the share repurchase (as well as the share resale) is subject to a stamp duty of 0.15% of the consideration, whereby the securities dealer as a party owes a half duty for itself and another half for any counterparty that is not a securities dealer. If the company is a bank or a professional securities broker, it is exempt from its own half duty in respect of any transaction made for its own trading portfolio — transactions for the investment account are, however, not exempt. The single, labelled account is deemed to form part of the investment account. Hence, any transfer of shares from the collective account to the single account is deemed to be a taxable transfer for stamp duty purposes.