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DEMERGER, SWITZERLAND, TAX NEUTRALITY

Swiss Federal Supreme Court Renders Decision on Tax Neutrality of a Holding Company Demerger

Peter Reinarz (**Bär & Karrer AG**) / **April 18, 2019** / **Leave a comment**

With its ruling dated 11 March 2019 (case no. **2C_34/2018**) the Swiss Federal Supreme Court upheld a decision of the Court of Justice of the Canton Geneva, according to which it was principally possible for a Swiss holding company to undertake a tax-neutral demerger, such that the existing holding company could transfer just one qualifying participation in an underlying active subsidiary to a newly formed, parallel second holding company without triggering any income tax consequences (such as taxation of latent hidden reserves or unrealized gains) at the corporate level, nor any personal income tax consequences at the level of the individual shareholders of the holding company being divided and split-up, provided that the transferring holding company continued to own at least one qualifying participation after the demerger. For these purposes a qualifying participation generally represents an equity stake of at least 20% in an active subsidiary. The Federal Supreme Court thereby rejected the published position of the tax authorities which required the ongoing presence of “several” (i.e. at least two) active subsidiaries at the level of both the transferring and the demerged holding companies as a condition precedent for an income tax neutral demerger.

Facts and History of the Case

The case before the Supreme Court concerned a Geneva resident private individual, Mr. A.,

who owned 50% of the shares in the Geneva based company C. SA, which was a holding company that owned several majority interests in active subsidiaries. The remaining shares of C. SA were owned by another individual; both of them also served as directors on the board of C. SA. Towards the end of the year 2010, the directors of C. SA decided to implement a demerger from C. SA by forming a new, parallel holding company ("X. SA"), to be held by the same individual shareholders in the same proportions as C. SA, and by having C. SA transfer to X. SA. certain assets – notably, liquid funds of almost CHF 600,000, 100% of the shares of one of the subsidiaries then held by C. SA ("Y. SA") which had a book and net asset value of CHF 300,000, and a minor receivable balance towards another subsidiary of C. SA, altogether representing a total (book) value of some CHF 900,000. The demerger plan had provided that X. SA would be formed with a nominal share capital of CHF 100,000 and reserves of some CHF 800,000, together representing the book value of the assets to be transferred from C. SA to X. SA, with retroactive effect for accounting and corporate tax purposes as of 1 July 2010. At the same time, the aggregate nominal share capital of C. SA would be reduced by CHF 100,000. The Geneva Cantonal Tax Administration, when proceeding with the individual tax assessment Mr. A., requested that evidence be provided that the assets transferred by C. SA to X. SA pursuant to the demerger project constituted a going concern business, and that the two companies resulting from the demerger (i.e. C. SA and X. SA) were both carrying on a genuine holding activity (before and after the demerger), both using their separate own employees or externally contracted staff. C. SA responded by stating that the assets transferred to X. SA constituted a going concern business, as Y. SA (the subsidiary transferred to X. SA) was an active asset management company that was employing its own personnel, and furthermore, that both C. SA and X. SA were exercising a "genuine" holding activity.

The cantonal tax administration challenged that response on the basis that Y. SA had not accounted for any personnel expense, nor any operating revenues during the year 2010, which apparently had been Y. SA's first business year. Eventually the tax administration assessed Mr. A for additional personal taxable income arisen in the tax year 2010 of some CHF 400,000 in terms of a constructive dividend, equivalent to 50% of the retained earnings/reserves which C. SA had transferred to X. SA. In doing so the administration applied the so-called "triangular theory", according to which open or disguised distributions of profits or reserves from a company to a sister company must first be attributed to the common shareholders of the two entities, and then be treated as a capital contribution made by the shareholders to the parallel (sister) company.

An objection raised by Mr. A against that personal tax assessment was rejected by the administration. Upon judicial appeal made by Mr. A, the first instance Administrative Court of the Canton Geneva amended the assessment in part in Mr. A.'s favor, by conceding that the deemed distribution made by C. SA to Mr. A should be partially (i.e. 40%) exempt from federal and cantonal/municipal income taxes as a qualifying dividend from a 10% or higher corporate equity participation.

However, upon Mr. A's second appeal the second instance Cantonal Administrative Court reversed the judgment of the lower court in his favor. The second instance court reached the conclusion that the demerger in question in fact did meet the criteria of a tax-neutral demerger in the meaning of the relevant statutory tax rules and the administrative regulations stipulated in the Circular letter no. 5 concerning "Restructurings" issued by the Federal Tax Administration (FTA) on 1 June 2004 ("Circ. 5"). On that basis, the second instance court concluded that the demerger was also income tax neutral at the level of the (Swiss resident) individual shareholders.

With the support from the FTA, the Geneva Cantonal Tax Administration filed a public law appeal to the Federal Supreme Court, asking to reverse the upper cantonal court's judgment and to confirm the income tax assessment of a constructive dividend against Mr. A in application of the "triangular theory", on grounds of wrong determination of the facts and wrong application of federal and cantonal tax laws by the upper cantonal court. However, the Federal Supreme Court confirmed the conclusions of the second instance cantonal court and rejected the appeal of the tax administration

Reasoning adopted by the Federal Supreme Court

The Supreme Court first reiterated that it would generally only review questions of law. A complaint concerning the determination of the relevant facts by the previous judicial instance can only be heard by the Supreme Court, if it is maintained and demonstrated in the appeal that the determination of the facts made by the previous court was manifestly wrong, i.e. arbitrary. The appeal of the tax administration had failed to meet that requirement.

Corporate tax analysis as preliminary question

The Supreme Court held that the key issue in the case at hand was the question whether there is any condition under applicable federal and cantonal tax laws for a demerger from a holding company to qualify as a tax-neutral reorganization, requiring the transfer of more than one qualifying participation to the demerged entity in order to meet the "business operation" test, and requiring the remainder and continuance of more than one qualifying equity participation at the level of the demerging entity, as had been suggested by the tax administration.

The Supreme Court confirmed the opinion of the upper cantonal court, that there is in fact no such legal requirement for the tax neutrality of a holding company's demerger. In the light of the fact that both holding companies emanating from the demerger (C. SA and X. SA) were employing their own personnel, and both holding companies continued to exist as holding companies, each of them holding at least one qualifying corporate equity participation of at least 20%, the Supreme Court concluded that the conditions for tax neutrality of the demerger in question were all fulfilled. The demerger in question constituted a "symmetric" demerger,

whereby the demerged entity would end up being owned by the same shareholders in the same proportions as the transferring entity had been owned prior to the demerger.

The Supreme Court referred to the general doctrine, as reflected in the relevant provisions of Swiss corporate tax laws (in particular art. 61 (1) (b) of the Federal Direct Taxes Act, FDTA), according to which unrealized gains ("hidden reserves") of a corporate entity shall not be taxed in the context of a qualifying restructuring, where the corporate entity in question remains subject to Swiss corporate tax liability and the income tax values of the assets affected by the restructuring are carried on by the involved corporate entities, whereas specifically in the case of a demerger, one or more going concern business operations or partial businesses (as opposed to single assets) must be the object of the demerger, and each of the entities resulting from the demerger must continue to carry on at least one such business operation or partial business. In the Swiss legal doctrine, this is commonly referred to as the "dual business operation requirement" applicable to demergers. In the tax reform enacted in connection with the introduction of the Swiss federal Merger Act, the "dual business operation" requirement was introduced as a substitute for the five-year blockage period (i.e. sale restriction) which had applied under the previous tax regime. The Supreme Court referred to sections 4.2.3.5 and 4.2.3.6 of Circ. 5.

Section 4.2.3.5 details the business operation requirement for income tax neutrality of demergers generally, from the FTA's point of view. The notion "business operation" means an organizational-technical complex of assets which form a relatively independent, organic unit for the entrepreneurial performance. The "partial business" is described as the smallest possible organism of a business which could independently exist. According to the FTA, a company carries on a business operation or a partial business, if all of the following three conditions are met:

(a) The company performs in the market or towards affiliated entities;

(b) The company has its own personnel; and

(c) The personnel expenses are reasonable, i.e. in proportion to the revenues.

Section 4.3.2.6 defines specific criteria for demergers of holding and asset management companies. It is stressed that the holding and management of securities merely for the purpose of investment of a company's own capital never constitutes a "business operation", even in the case of large portfolios. According to the FTA, the tax neutrality of a demerger of a holding company requires the fulfillment of all general conditions (continuance of corporate tax liability in Switzerland, continuance of the current income tax values, "dual business operation" requirement"), as well as fulfillment of all of the following specific conditions:

(a) The investments in subsidiaries must predominantly concern active companies;

(b) The investments concerned must predominantly represent equity participations of at least

20%, or warrant the exercise of a controlling influence by other means (such as through a shareholders' agreement);

(c) The entities arising from the demerger must each effectively carry out a holding company function (coordination of the business activities of several subsidiaries, strategic leadership) through their own personnel or through external mandates; and

(d) Continued existence of the holding companies arising from the demerger.

With its decision, the Federal Supreme Court appears to have effectively abolished the condition (c) above, as it has held that at least one qualifying (active) investment for each holding company resulting from the demerger may be sufficient for the holding company demerger's income tax neutrality. The Supreme Court considered explicitly that the FTA's requirement of a transfer of more than one qualifying investment is not supported by the wording of applicable statutory law (art. 61 (1) (b) FDTA), but only by the text of the Federal Council's legislative message, which had still been inspired by the previous tax law regime that did not feature the "dual business operation" requirement, but rather a blockage period. Furthermore, the Supreme Court stressed that in the case at hand, the single investment transferred to the demerged entity was a 100% participation in an active and operational subsidiary, which by itself represented a "business operation" with all of its assets.

Implications for individual taxation at the shareholder level

The Supreme Court then moved on to analyze the tax consequences of the demerger at the shareholder level. The Court first referred to the "triangular theory" based on art. 17 (1 in fine) and art. 20 (1) (c) FDTA, according to which actual or constructive dividends between sister companies have to be first attributed, for income tax purposes, to the common shareholders of both entities (who are then deemed to make a corresponding capital contribution to the sister entity receiving the benefits). The Court considered that the personal income tax provisions pertaining to shareholders in the context of restructurings are not very specific as they do not explicitly address the situation of a tax-neutral demerger. In particular, art. 61 FDTA only deals with the transfer of "hidden reserves" (latent gains) at the corporate level, but does not address the specific income tax issue of constructive dividends pursuant to the "triangular theory", which affects the shareholders of the demerging entity, and which is not identical to the issue of the hidden reserves at the corporate level. The Court referred to the legislator's general intention to facilitate several types of corporate restructuring and to remove existing tax hurdles that could prevent the taxpayers from using the legal instruments offered by the Merger Act. The Court also included a reference to the Merger Directive of the European Union (directive 90/434/CEE dated 23 July 1990, in particular art. 8 § 1), even though European law is not directly applicable in Switzerland. This lead the Supreme Court to the fundamental conclusion that, once a

restructuring such as a demerger is income tax neutral at the corporate level, it shall principally also be income tax neutral at the level of the shareholders of the entities involved in the demerger. Thus, since in the case at hand, the holding company demerger was considered to be income tax neutral for the companies involved, it followed that there was no room for application of the "triangular theory"; instead the demerger was also income tax neutral at the shareholder level. The same principles were obviously held to be applicable at the Geneva cantonal/communal tax level as well.

Final remarks

For dividend withholding tax purposes, tax neutrality of the demerger requires in addition that the aggregate amount of open and hidden reserves of the transferring and the demerged entity corresponds to at least the amount of open and hidden reserves prior to the demerger. The same is also a condition for the absence of any personal income tax consequences for Swiss resident private individuals – "conversion" of any reserves that are subject to a contingent personal income tax burden upon distribution into funds that may be returned to the shareholders without any income tax consequences (such as nominal share capital) would trigger immediate personal income taxation. The exemption of the demerger from any stamp duty consequences is tied to the income tax neutrality at the corporate level.

It remains to be seen if and how the Swiss tax authorities will apply this Supreme Court decision going forward. The direction given by the Federal Supreme Court should provide companies more flexibility, in particular to transfer a sole sub-holding entity with several subsidiaries, or even a single active subsidiary to the demerged company in a tax-neutral manner. Under Swiss tax laws, this can even be done in view of a subsequent sale of the shares of either the demerged or the transferring company.

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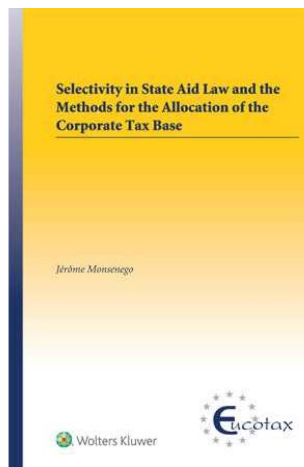

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