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Supreme Court decision eases tax-free intra-group transfers of qualifying participations

By ruling against Circular Letter No.10 of the Swiss Federal Tax Administration, the Swiss Federal Supreme Court has recently relaxed the requirements for an income tax-free transfer of qualifying participations from a Swiss company to a non-Swiss company within the same corporate group.

Amendments to the Federal Income Tax Act in 1998

With the entry into force of amended Article 70 of the Federal Income Tax Act *(Bundesgesetz über die direkte Bundessteuer;* "FITA"*)* on 1 January 1998, corporations or mutual companies with a participation *(Beteiligung)* in an investee company which had a market value of at least CHF 2,000,000 or comprised 20% of the investee company's share capital became entitled to an exclusion from capital gains taxes resulting from the sale or transfer of all or part of the participation if, cumulatively, (a) the participation transferred or sold amounted to at least 20% of the share capital, (b) the participation was acquired after 1 January 1997 and (c) the participation was held for at least one year.

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Capital gains on qualifying participations acquired before 1 January 1997 and disposed of before 1 January 2007, however, remain subject to federal income taxes without any limitation. Article 207a paragraph 3 FITA included transition rules for transfers of participations within corporate groups and provided that if a participation acquired before 1 January 1997 is transferred to a non-Swiss company within the group, then the tax on the resulting capital gain will be imposed only if the participation is sold to a third party before 1 January 2007. Twenty-five of the twenty-six cantons implemented an equivalent capital gains exclusion in their own legislation for cantonal and municipal income taxes.

It should be noted, however, that the capital gains exclusion is of no importance to companies which benefit from the so-called cantonal and municipal holding privilege and are therefore already exempt from cantonal and communal income taxes. Such holding privileges are granted if either two thirds of the company's income is derived from dividends or two thirds of its assets consist of participations in other companies and the company does not pursue an active business in Switzerland.

Federal Tax Administration Circular Letter No.10

The Swiss Federal Tax Administration *(Eidgenössische Steuerverwaltung)* interpreted Article 207a FITA in its Circular Letter No.10, which was issued on 10 July 1998 and was binding on the cantonal tax administrations in their assessment of federal income taxes. Circular Letter No.10 limited the tax-free transfer of qualifying participations within a corporate group to two cases: the company transferring such a participation is a Swiss company and (a) retains the majority voting power in the foreign group company receiving the participation or (b) the foreign group company receiving the participation remains under the control of the Swiss parent company, which holds the majority voting power in the Swiss transferee company.

Swiss Federal Supreme Court Decision of 6 January 2004

On 6 January 2004, the Swiss Federal Supreme Court rendered a decision in a case involving the transfer by a Swiss company of its participation in a Spanish company to the Dutch parent company of the Swiss company. The court ruled that limiting the application of Article 207a paragraph 3 FITA to Swiss-controlled companies went beyond the text of the act. It held that the term "group" means a group of legally independent enterprises with a common economic leadership, regardless of the domiciles of the various enterprises. The court also held that the explicit aim of Article 207a paragraph 3 FITA was to increase the attractiveness of Switzerland, not only for ultimate holding companies, but also for intermediary holding companies. Unfortunately, the court left open whether the interpretation of the Federal Income Tax Act violated the non-discrimination rules set out in Article 24 paragraph 5 of the OECD Model Tax Convention on Income and Capital which also has been integrated into many of the bilateral treaties for the avoidance of double taxation concluded by Switzerland.

Consequences

The Federal Supreme Court's decision overruled the Federal Tax Administration's Swiss control requirement in Circular Letter No.10. Assuming that the administrative practice will change in accordance with this decision, as can be expected, Swiss intermediary holding companies may now sell their participations acquired before 1997 at book value or fair market value to any group company without triggering federal income taxes. It is in the competence of the cantons that implemented the Article 207a paragraph 3 FITA exclusion in their own legislation to decide whether to relax their own practice. Nonetheless, it can be expected that at least some cantons, possibly upon challenges by taxpayers, will follow the Federal Supreme Court's interpretation in respect of cantonal and communal taxes as well.

The Federal Supreme Court's decision should permit foreign groups under a Swiss intermediary holding company to reorganise their group structure without immediately facing Swiss federal income taxes. They will not be forced to either pay income tax on the capital gain or wait until 2007 to do what might be necessary or desirable from a commercial point of view. The Federal Tax Administration will now issue new guidelines for the income tax free transfer of investments held by Swiss companies to non-Swiss affiliated companies. This might permit Swiss companies to more readily or completely benefit from the EU Parent-Subsidiary Directive because group dividends may be distributed free of withholding tax.

In cases where relevant transactions were performed before the Federal Supreme Court's decision and the Swiss transferor company has not yet been finally assessed on the capital gain taxes, amending the tax declarations or filing respective protests with tax authorities should be considered.

Despite the Federal Supreme Court's decision and the expected new administrative practice, it is recommend that taxpayers obtain a binding tax ruling before distributing the proceeds of participation sales to the shareholders of Swiss holding companies. With some careful planning, Swiss withholding tax *(Verrechnungssteuer)* also might be reduced, if not eliminated, by the application of an available double taxation treaty. If a tax-efficient distribution of the proceeds cannot be made or is not desired, then the proceeds of the sale could, for example, be loaned to a foreign group company, which might result in interest income in Switzerland that is taxed at a comparatively favourable rate and an interest expense for the foreign affiliate which may be subject to a higher income tax rate.

It is expected that upon conclusion of the Bilateral Agreements II between the European Union and Switzerland, the rules of the EC Parent-Subsidiary Directive also will become applicable to Switzerland. If so, Swiss withholding tax on distributions in respect of shares to parent companies in all European countries would be reduced to zero.

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