

Purchase of a Participation and Indirect Partial Liquidation



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If an individual shareholder resident in Switzerland sells shares or other forms of equity participations in a business which were the shareholder's private assets (i.e., a passive investment) and after the sale the participations become part of the business assets of the purchaser, then the seller may be required to pay income tax on the gain realized from the sale of the participations if assets are thereafter removed from the business.

Such a sale of participations – if the purchase price is fully or partially funded out of assets of the relevant business – is considered an indirect partial liquidation (*indirekte Teilliquidation*) for tax purposes. As a result, a normally tax-free private capital gain is converted into taxable investment income in the hands of the individual shareholder. This is particularly true if the relevant business has distributable reserves and/or hidden reserves.

Supreme Court Decision and Circular Letter No 7

In its decision dated June 11, 2004, the Supreme Court limited the existing practice of the Swiss federal tax authorities with regard to the taxation of an indirect partial liquidation. The Swiss Federal Tax Administration (SFTA) adopted the court's opinion in its Circular Letter No. 7 (KS 7) concerning the indirect partial liquidation and made its application mandatory for Swiss federal taxes. The new practice of the SFTA under KS 7 resulted in the repeal, in most cases, of the five-year restricted period. Further, if the purchase price of the shares is financed with borrowed funds the restricted period is extended until the purchaser has amortized the debt out of its own earnings. During the restricted period, the acquired business may not pay dividends or otherwise distribute profits to its owners.

Adverse Actions by the Purchaser – Current Practice

In order to avoid the adverse tax consequences of the indirect partial liquidation rules, the following actions should not be taken during a period of five years after the purchase of the acquired company:

- Pledging or otherwise using the shares or assets of the acquired company as security for a loan used to finance the acquisition of the acquired company's shares;

- Lending by the acquired company to the purchaser of its shares;
- Making distributions or concealed distributions from the assets of the acquired company;
- Making distributions or concealed distributions from the future profits of the acquired company;
- Merging the acquired company with the acquiring company;
- Liquidating the acquired company or terminating its business operations;
- The seller making a loan to the purchaser of the acquired company.

Hence, all actions which (1) reduce the value of the acquired company during the five-year restricted period and (2) in any way have the economic effect of financing the purchase price paid by the purchaser of the acquired company have an adverse tax consequence. In the case of a merger between the acquirer and the acquired company, a total liquidation of the acquired company will be deemed to have occurred, with the consequence that all hidden reserves of the acquired company will be included in the taxable income of the seller.

In the case of Swiss federal income taxes, a distinction is made on the basis of whether the purchase price was paid from the acquirer's own resources or whether funds had to be borrowed for that purpose. In this regard, financing provided to the acquirer by other companies in the corporate group does not lead to an adverse tax consequence so long as it can be demonstrated that no third-party financing was provided. If third-party financing was used for the payment of the purchase price, then in most cantons the restricted period, which is usually five years, will be extended for an unlimited period of time. During this restricted period dividend distributions paid out of future profits will trigger the indirect partial liquidation.

New federal Law Passed

On June 23, 2006 a new Swiss federal law was passed. This law governs the taxation, on both the federal and cantonal level, of an indirect partial liquidation involving the sale of a participation equal to 20 % or more of the nominal share capital of the relevant company and limits the restricted period to a maximum of five years. Moreover, only the assets of the company which are not required for its operations and which could have been legally distributed on the date of purchase may be included in the taxable income of the seller, provided that the seller knew, or should have known, that after the sale assets would be withdrawn from the acquired company for the purpose of financing the payment of the purchase price. The new law will become effective on January 1, 2007.

Impact of New Law on the Present Practice

The new law significantly improves the tax position of the purchaser. The most important change is that under the new law only assets which were not required for the operation of the business and which were legally distributable may be subject to taxation. Distributions of future earnings are not included in the taxable income of the seller. Under the currently applicable administrative tax rules, the merger of the acquired company with the acquiring company causes an indirect total liquidation, with the result that all disclosed and hidden reserves can become subject to taxation. The difference between the purchase price and the par value of the company's share capital is used to determine the amount subject to tax. Whether this administrative practice can still be properly applied in light of the new law is questionable. It is therefore highly recommended that the transaction be discussed with the tax authorities before it is executed.

Ruling procedure

Before the execution of the purchase agreement, an advance ruling should be obtained which confirms that if none of the actions by the purchaser with adverse tax consequences described above is taken during the five-year restricted period, then no indirect partial liquidation will result. Likewise, the amount of the assets which are not required for the operation of the business should be determined and confirmed by the tax authorities. The five-year restricted period also will be applicable on federal level, even if the purchase price is debt-financed.

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