Tax simplifications for M&A transactions – Switzerland

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Foreign investors considering the purchase of a Swiss company very often come across a specific particularity of Swiss tax law that in many cases complicates matters significantly. An important issue that foreign investors may be unaware of is the fact that the owner of the target company, if he is an individual, wants to make sure he realizes a tax-free capital gain upon the sale of his company. Whether he achieves this goal or whether the capital gain realized is re-qualified as taxable dividend income in application of the so-called indirect partial liquidation theory depends heavily on the post-acquisition actions taken by the purchaser of the company.

As a result, an individual seller will very likely impose far-reaching restrictions on what the purchaser may or may not do with the target company subsequent to the transaction. Alternatively, the seller may request language in the sales and purchase agreement that will compensate him in case he will be required to pay income taxes on his capital gain. Recent changes in Swiss tax law have been implemented to mitigate this point and give individual shareholders more certainty about the tax treatment of their capital gain. In the following, a closer look is taken at this important particularity in M&A transactions involving a Swiss target.

The principle of tax-free capital gains on the sale of shares

As of 1 January, 2007, the application of the indirect partial liquidation theory has been regulated in the Swiss tax law. Thereby, the negative tax consequences for individuals selling controlling shareholdings – which were brought upon by a Federal Supreme Court decision issued in June 2004 – have largely been reversed. According to current Swiss tax law, capital gains resulting from the sale of privately held assets are – with the exception of real estate – tax free. For more than 20 years, the practice of the Federal Supreme Court has put a limit on the principle of tax-free capital gains upon the sale of controlling shareholdings. It allows the tax authorities to – under certain circumstances – requalify a capital gain upon the sale of shares into a taxable dividend income. At the outset the intention of the indirect partial liquidation theory was to counter the avoidance of income tax by an individual owner of a company at the time of the sale of his shareholding. By not making regular dividend distributions – which are taxable to the receiving shareholder – but instead obtaining a higher sales price, an individual shareholder was able to avoid paying income taxes on the retained earnings of his company. Since a Swiss corporate buyer is able to take out the non-distributed earnings of the acquired company by means of a tax-exempt dividend, the retained earnings in the target company were in fact never taxed at all.

Federal supreme court decision as a turning point

The broadening of the application of the indirect partial liquidation theory reached a new height when the Federal Tax Administration, as a consequence to a Federal Supreme Court decision of June 2004, issued a draft for new guidelines. These guidelines stipulated that not only the distribution of retained earnings existing at the time of the sale of the company should constitute an indirect partial liquidation but also the distribution of future retained earnings of the target – if the acquiring company had been financed with debt. As a result of this adverse development, leveraged buy-outs, management buy-outs, and particularly succession planning for small and mid-size companies became in many cases virtually impossible in Switzerland. Since most potential buyers were reliant on debt and on distributions from the target to finance the acquisition costs, the assumption of an indirect partial liquidation and connected thereto the negative tax consequences to the selling shareholders could hardly be avoided. This received heavy criticism within the financial as well as the political community which resulted in a number of motions in parliament. These eventually led to the new provision in the law, through which the excessive interpretation of the indirect partial liquidation-theory was to be reversed.

The new legal definition of an indirect partial liquidiation

The new provision in the income tax law intends to reinstall the situation as it was prior to the aforementioned Federal Supreme Court decision. Most importantly distributions made out of earnings realized after the sale of the company shall no longer have any adverse income tax implications to the seller even if the acquisition was debt financed by the buyer. The proceeds from the sale of a controlling shareholding by an individual to a corporate buyer will always qualify as a tax-free capital unless, funds which at the time of the sale were (i) not operationally necessary and (ii) legally available for distribution are distributed within the following five years.

More specifics are expected from guidelines to be issued by the Federal Tax Administration early in 2007 regarding the question about what constitutes non-operationally necessary funds. Regarding the funds available for distributions, based on commercial law only free reserves, retained earnings and the general legal re-serve to the extent it exceeds 50% (20% for holding companies) of the company's share capital can qualify. Not available for distribution are reserves for own shares, revaluation reserves plus 'hidden' reserves resulting from differences between book and fair market values.

Conclusion

The stipulation of the indirect partial liquidation theory in Swiss tax law put a halt to the ever broader interpretation of that concept to the detriment of individual share-holders selling a controlling stake in their company. It is destined to reinstall legal certainty about the tax consequences of M&A transactions involving individual shareholders. From the point of view of the buyer, it is important that the potential tax ramifications to the seller will no longer impede him to use debt to finance such an acquisition. As a consequence, an upswing in M&A activities in the Swiss market can be expected for this year. Regardless of the new provision in the Swiss tax law, it is still highly recommended for individuals to ask for a binding ruling from the competent tax authorities prior to entering into a sale of their shareholding. This holds particularly true if the buyer intends to implement post-acquisition restructurings to optimise the income tax situation.

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