

Corporate Taxation in Switzerland

Case Studies

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Tax Planet | Tax Advisors Worldwide
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October, 2013

1. Dividend payments

1.1 Relief on incoming dividend payments

Federal: Switzerland has a classical corporate tax system that results in economic double taxation. Shareholders are charged a second time on dividend income, only dividend income from substantial participations is shortened to partly reduce this effect. Nevertheless, Switzerland has low tax rates and the aggregate tax burden may anyway be lower than in other countries.

To avoid multiple taxation, intermediate companies receiving dividends or capital gains derived from qualifying holdings may apply for tax relief. This relief is available to Swiss corporations, cooperatives as well as to foreign companies of a similar nature who maintain a permanent establishment in Switzerland and the dividends or capital gains are linked to the Swiss operations. The relief is available regardless of the nature of the activities and the country of residence of the shareholders.

To qualify for relief on dividend income, the participation must represent at least 10% of the registered capital of the paying company or the market value of the participation must exceed CHF 1 million.

1. Dividend payments

1.1 Relief on incoming dividend payments

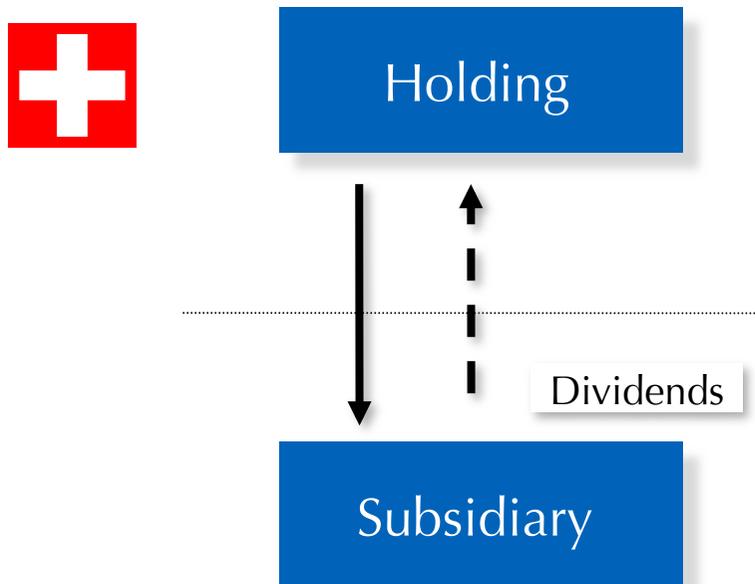
Cantonal: The same treatment as at federal level applies with regard to the participation relief. However, at cantonal and municipal level also exists the so-called holding company status. Companies who qualify for the holding company status are widely tax exempt, if the main purpose as per articles of incorporation and in fact is the management of long-term financial investments in affiliated companies. At least 2/3 of the assets (or income) must be derived from long-term participations. Furthermore a holding company may not be engaged in commercial activity in Switzerland.

Foreign withholding tax (WHT): If dividend income is subject to foreign not fully refundable WHT, the relief provided in Switzerland on this remaining WHT will be either an effective or lump-sum credit against the corresponding Swiss tax, or of second priority a deduction from the corresponding dividend income in Switzerland.

In case of a participation relief or the existence of a cantonal holding company status, the non-refundable part of the foreign WHT will be a definite residual tax burden for the receiving Swiss holding company.

1. Dividend payments

1.1 Relief on incoming dividend payments



Facts

Net dividend payment 200

Total profit generated:

- 1) 1'000, Federal tax 78
- 2) -500

Participation

- a) 5%, 8%
- b) 10%
- c) 8% and fair value minimum
CHF 1 million

1. Dividend payments

1.1 Relief on incoming dividend payments

Solution

- 1a** No tax relief on the incoming dividend payment, only credit for the foreign non-refundable withholding tax (WHT) against the corresponding Swiss tax
- 1b, 1c** Tax relief: $200 / 1'000 \times 78 = 15.6$
Non-refundable foreign WHT is an expense, reducing taxable income
- 2a** No exemption and no credit for the foreign non-refundable WHT, since there is no tax burden in Switzerland. The foreign WHT is an expense only, reducing the taxable income
- 2b, 2c** No tax relief, since there is no tax burden in Switzerland. No carrying forward. The foreign WHT is an expense, reducing the taxable income

1. Dividend payments

1.2 Continuing dividend distribution

Federal: The continuing dividend distribution from the dividend receiving Swiss holding company (now Swiss subsidiary) to its foreign parent company is subject to WHT of 35%, levied at source.

As of January 1, 2005, the foreign parent may file for applying the reporting mode (Meldeverfahren). In that case only the residual WHT will be levied at source so that no refund has to be required. This is an administrative relief.

With regard to the EU a zero rate WHT applies for substantial participations of at least 25% of the share capital of the subsidiary held by the parent company for a period of at least 2 years.

A US-parent company is facing a non-refundable WHT of 5%, if the participation in the Swiss subsidiary is at least 10%. With regard to Russia the non-refundable WHT is also 5%, but the participation in the Swiss subsidiary must be at least 20%.

1. Dividend payments

1.2 Continuing dividend distribution



2. Deductibility of dividend related expences

Federal: Interest are tax deductible if not exceeding the save haven limits given by the Swiss tax authority. Also administrative expences are deductible. Since dividend related expences not only reduce the corporate profit, but also the net qualifying dividend income, the percentage of participation relief is affected accordingly.

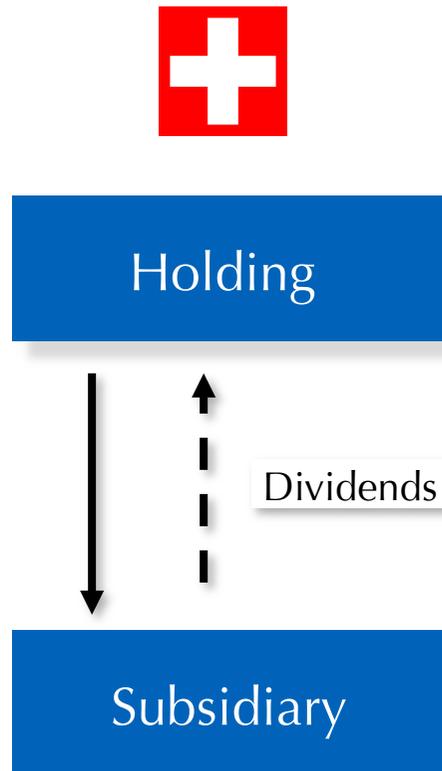
The formula to compute the participation relief consists of a counter and a denominator. Bear in mind that any dividend related expence affects both, the counter and the denominator of the formula. Thus, in case of a holding company without any other income, the exemption will be 100%, regardless of expences being taken into account.

The allocation of interest expence to dividend income is done in proportion to the assets on the basis of the relevant tax base for income tax purposes (Gewinnsteuerwerte).

Also back-to-back-financing within a corporate group is harmless for the deductibility of interest expence within the save haven limits.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exeptions).

2. Deductibility of dividend related expenses



Facts

Balance Sheet			
Subsidiary	3'000	Equity	500
Other Assets	1'000	Liabilites	3'500
	4'000		4'000

Income Statement			
WHT	40	Dividend	800
Interest expense	320	Other income	200
Other expenses	140		
Net profit	500		
	1'000		1'000

2. Deductibility of dividend related expences

Solution

Calculation of the net dividend income for tax relief

Pro rata liabilities related to participations	$3000 / 4000$	=	75%
Pro rata interest expense	$75\% \times 320$	=	240
Administrative expenses (lump sum 5%)	$5\% \times (800 - 40)$	=	38
Dividend payment	800		
Less WHT	- 40		
Less Interest expense	- 240		
Less administrative expenses	- 38		
Net dividend income	482		
Tax Relief	$482 / 500$	=	96.4%

3. Thin capitalisation

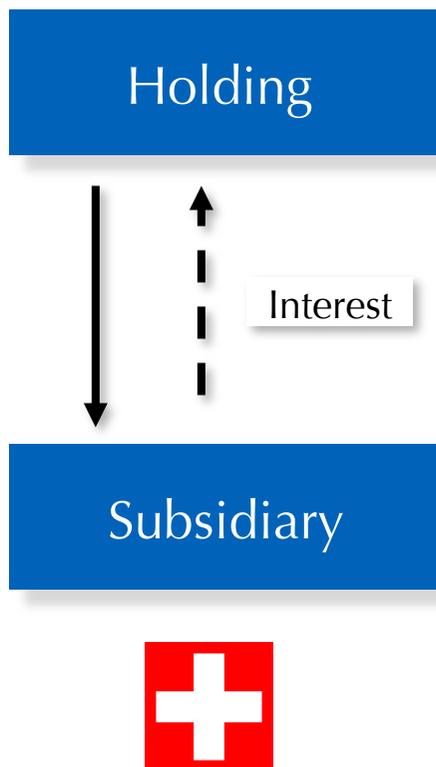
Federal: The rules aim at financing structures with high debt-equity ratios. Interest is tax deductible, dividend payments are not. High debt-equity ratios can reduce the tax burden on business profits. Interest payments in thinly capitalized companies may therefore be partly disregarded as interest expense and regarded as a constructive dividend.

The calculation of the ratio is usually done on the basis of the fair market value of the assets at the end of the tax period. Large changes within a tax year - by value or by substance - may be taken into account. If no reliable fair market value is at hand, tax authorities will set up on the relevant tax base for income tax purposes (massgebender Gewinnsteuerwert). The accepted debt-equity ratio differs from asset class to asset class. For financing companies the maximal accepted ratio is 6/7 of total assets.

Hidden equity is regarded as the part of debt beyond accepted debt-equity ratios, provided that the debt is funded by shareholders with a dominant influence on relevant decisions. The intention of committing tax avoidance needn't be given. Also back-to-back financing may be object of a thin capitalisation treatment when discovered. In case of credit guarantees and collaterals to credit providers (banks etc.) for affiliates, an application may very likely not take place.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exceptions).

3. Thin capitalisation



Balance Sheet of Subsidiary

Assets	4'000	Equity	200
		Loan from Holding	400
		Other Liabilities	3'400
	4'000		4'000

Fair Market Value of Assets = 5'000

Accepted debt-equity-ratio e.g. 70% = 5'000 x 70% = 3'500

Hidden Equity = 400 – (3500 – 3400) = 100

Interest on 100 will be recharacterized as Dividends

4. Valuation principles for participations

Federal: Due to a lower fair market value of a participation, write-offs are always tax deductible when indicated by accounting rules stipulated by the relevant tax and/or business laws. However, in case of a value recovery write-offs must be reversed, what will have tax effects to the opposite direction. Accepted valuation methods are the Equity-method, the DCF-method, and any other traditional method for business valuations.

In case of a value impairment due to a substantial dividend distribution in the same business year, write-offs are not tax deductible. Further consequences: The participation relief on the corresponding dividend income is reduced accordingly, and the book value (tax base) of the participation is increased by the same amount for further tax assessments.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exceptions), and thus losses on participations are of no relevance.

5. Capital gains/losses on the sale of participations

5.1 Tax relief on capital gains

Federal: Capital gains on the sale of substantial participations of at least 10% of the registered capital of the subsidiary, and held over a period of at least 1 year, qualify for the participation relief (see point 1.1).

A capital gain is defined as the positive difference between the sale price and the acquisitions costs (steuerlich massgebende Gestehungskosten), as regarded for income tax purposes. An eventual difference between the acquisition costs and the actual tax base for income tax purposes (Gewinnsteuerwert), e.g. due to write-offs in previous years, is thereby reversed and is subject to ordinary corporate income tax.

To figure out whether the requested 10% quorum is given or not, sales performed over one business year are added up.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exceptions).

5. Capital gains/losses on the sale of participations

5.1 Tax relief on capital gains

Facts

Period of holding

- 1) 6 Monate
- 2) 13 Monate

Participation quote

- a) 5%, 8%
- b) 10%

Original costs	1'500
Tax base	1'000
Sale price	2'500
Capital gain	1'500

Holding



Subsidiary



Solution

1a, 1b, 2a:	
Taxable capital gain	1'500
2b:	
Taxable capital gain	500
Tax exempt capital gain	1'000

5. Capital gains/losses on the sale of participations

5.2 Deductibility of capital losses

Federal: A capital loss is the negative difference between the sale price and the acquisition costs of the participation for income tax purposes (steuerlich massgebende Gestehungskosten), and is tax deductible. An eventual difference between the original costs and the actual tax base for income tax purposes (Gewinnsteuerwert), e.g. due to write-offs in previous years, is thereby reversed and shortens the capital loss or may even create a book profit that is subject to ordinary corporate income tax.

In case of a capital loss in combination with a substantial dividend payment from the same participation in the same business year, the capital loss will only be tax accepted to the extent the loss is surpassing the dividend payment, either by offsetting against the dividend income, what affects the participation exemption, or by non-acceptance of the tax deductibility.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exceptions).

6. Liquidation of a subsidiary

Federal: Participations in subsidiaries of at least 10% of the share capital or of a fair value of at least CHF 1 million qualify for the participation relief.

A liquidation surplus is the positive difference between the liquidation receipts and the acquisitions costs for the participation, as regarded for income tax purposes (steuerlich massgebende Gestehungskosten). An eventual difference between the acquisition costs and the actual tax base for income tax purposes (Gewinnsteuerwert), e.g. due to write-offs in previous years, is thereby reversed and shortens the surplus accordingly.

A liquidation loss is the negative difference between the liquidation receipts and the acquisition costs for the participation. An eventual difference between the acquisition costs and the actual tax base, e.g. due to write-offs in previous years, is thereby reversed and shortens the loss or may even create a book profit that is subject to ordinary corporate income tax.

Cantonal: The same treatment as at federal level. In case of a holding company status at cantonal level, all income is tax exempt (with some minor exceptions).

Foreign WTH: see point 1.1.

7. Liquidation of the holding company

Federal: Any income derived from the liquidation of the holding company is subject to corporate income tax at the level of the holding company. With regard to the liquidation of substantial participations the participation relief may apply (see point 5).

The liquidation results in a liquidation surplus or a liquidation loss, defined as the difference between the liquidation receipts and the relevant equity of the holding company (share capital plus paid in resp. agio reserves). The liquidation surplus distributed to the shareholders is subject to a WHT of 35%, levied at source. The repatriation of the nominal share capital and agio reserves has no tax effects.

As of January 1, 2005, the foreign parent may file for applying the reporting mode (Meldeverfahren). In that case only the residual WHT will be levied at source so that no refund has to be required. This is an administrative relief.

With regard to the EU a zero rate WHT applies for substantial participations of at least 25% of the share capital of the subsidiary held by the parent company for a period of at least 2 years.

A US-parent company is facing a non-refundable WHT of 5%, if the participation in the Swiss subsidiary is at least 10%. With regard to Russia the non-refundable WHT is also 5%, but the participation in the Swiss holding must be at least 20%.

Cantonal: The same treatment as at federal level. There is no WHT at cantonal level. In case of a holding company status, all income is tax exempt (with some minor exceptions).

8. Group internal financing companies

Federal and Cantonal: The circular of the Swiss federal tax authority regarding Swiss thin capitalization rules does not help in cross border cases, because the funded company is a foreign entity.

In conformity with general transfer pricing rules, international financing structures must reflect arm's length prices. Arm's length prices are those that would have been agreed between unrelated parties engaged in the same or in a similar transaction under the same or similar conditions and risks. The determination of an appropriate arm's length price is a delicate matter and differs from case to case.

If credit conditions do not reflect arm's length rules and interest expense at the level of the funded foreign company is recharacterized as dividend for tax purposes, Switzerland is, due to treaty law, obliged to make a corresponding adjustment (interest income to dividend income). The corresponding adjustment will usually be done in silent acceptance of the decision of the foreign tax authority or, in case the foreign adjustment is disputed, as result of a mutual agreement procedure.

The basic requirement to qualify for participation relief on dividend income is the non-acceptance as expense in the paying company. This principle also applies in cross border situations.

9. Refund of charged VAT

If the Swiss company is subject to VAT-liability, VAT on incoming bills can be deducted from the VAT that is charged on outgoing bills.

A positiv balance must be payed to the federal tax authority at the end of each quarter, a negativ balance will be refunded.

Companies who are not mandatorily subject to VAT-liability my apply for a voluntary subordination in order to get a refund for VAT charged on incoming bills.

10. Group taxation

The concept of group taxation is unknown under the Swiss tax law (direct taxes), each corporation is treated as a separate entity and files its own return. Offsetting of the loss of one entity with the profit of another entity within the same group is therefore impossible.

With regard to VAT group taxation is possible.

11. Principal companies

Federal and Cantonal: A Swiss principal company engaged in foreign manufacturing and sales activities will preferably do this on a contractual basis with limited risk manufacturers and distributors. The foreign limited risk contractors are thereby usually compensated on a cost-plus basis, so that the large part of the profit remains with the Swiss principal company.

Relief is granted through the allocation of large portions of the profit to the foreign activities (deemed foreign establishments). The residual profit is taxable at ordinary tax rates. This highly favourable tax regime can lead to very low tax burdens of less than 10% on overall profits.

12. Ruling practice

Federal and Cantonal: Switzerland has a well established ruling practice. It is quite common to discuss and negotiate difficult tax issues in advance with the competent tax authorities.

Advance rulings are binding for the signing tax authority. Thus, given that the relevant tax issue has been disclosed and negotiated completely and accurately, a tax ruling provides a high degree of legal certainty.

Tax rulings are processed rapidly and usually do not take more than 4 to 8 weeks until being signed.

Rulings also must be performed in a non-discriminatory manner.