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Tax pitfalls in share deals

"Share deals", that is, the sale and acquisition of shares in a legal entity, are one of the key forms of a transaction for the transfer of ownership in a company/business. Although conceived of as comparably simple, these transactions still pose a great number of challenges, particularly also in terms of tax considerations. The timely identification of the respective tax pitfalls is often critical to ensuring the efficient and successful completion of a transaction.

MOTIVES FOR TRANSFERRING COMPANY OWNERSHIP

Various motives can trigger a decision to transfer ownership in a company. These may include succession planning, acquisitions or divestments, restructuring, or management buyouts. Each situation requires a different approach, and is rich in challenges for the company, its management and its shareholders, as well as for the advisers involved in the process.

The full, or even partial, transfer of a business can be achieved in different ways. The transaction types most commonly used are the "share deal" and the so-called "asset deal", that is, a transfer of assets and liabilities. Other alternatives include mergers and merger-like transactions, or joint ventures, which – depending on the circumstances - may also be suitable for achieving the desired result. Common to all types of transactions is that, in addition to business considerations, the assessment and structuring of the tax situation is a central factor.

The present article is intended to provide a brief overview of the most important tax issues and pitfalls that arise in connection with share deals. Beyond the scope of this article however, and thus not addressed, are questions relating to the “regular” due diligence in tax matters of

Share deals are replete with tax challenges that it is important to identify early on in a transaction, in order to avoid surprises.

Thomas M. Schmid, Attorney-at-Law, lic., iur., LL.M.

the target company and the reflection of identified risks in contractual warranties and/or indemnifications.

Quite frequently tax issues mark a dividing line between the desirable structuring of a transaction and what is reasonably feasible.

ARE THE REALIZED CAPITAL GAINS TRULY TAX-EXEMPT?

Capital gains realized on privately held movable assets are, in principle, tax-exempt under Swiss tax law. Nevertheless, both court decisions and administrative practice set limits on the scope of this fundamental tax exemption in various situations. Among other things, a standard practice has emerged for dealing with so-called indirect partial liquidation and the so-called "transposition". The limits to the scope of the tax exemption in these two cases have, in the meantime, become law, and typically affect transactions where a Swiss investor sells privately held participation rights to a legal entity, or for inclusion in the business assets of another individual.

Indirect partial liquidation – Sale to third parties

Where a Swiss investor sells privately held participation rights to a legal entity or for inclusion in the business assets of an individual, and where the buyer uses existing equity substance of the target company to finance the acquisition, this is defined as an indirect partial liquidation. As a consequence of such qualification the seller will not realize the profit from the sale of the participation rights in the form of tax exempt capital gains, but, instead, as taxable investment income.

The background and intention of this concept is to secure the taxation of the existing equity substance of the target as income on the level of the selling investor, which taxes would normally have accrued would the relevant substance have been distributed to the investor in the form of dividends.

The criteria for a qualification as an "indirect partial liquidation" are met where (1) an individual resident for tax purposes in Switzerland (2) sells (3) participations rights of no less than 20% of the equity in a company (4) held as personal assets (5) to be included in the business assets of another natural or legal person, where (6) within a period of five years following the sale, (7) with the cooperation of the seller, (8) distributions are made by the acquired target company from existing equity substance.

As a consequence of the transfer of the participation rights into the business assets of a legal entity or individual, the existing equity substance of the target may in many cases be distributed to the buyer tax-free, in the form of dividends. The acquirer then uses those funds to finance the purchase price, so that the existing equity substance, de facto, passes to the seller tax-free in the form of the purchase price. The intention of the indirect partial liquidation is to prevent such transactions and re-qualify tax free capital gains as taxable income.

The tax consequences of an indirect partial liquidation thus do not necessarily come into effect at the time of the transaction, but rather if and when the purchaser distributes the existing equity substance within five years of the time the transaction was completed. Such distribution of equity substance may be considered to have occurred not only in the case of an actual distribution of dividends, but, under certain circumstances, and to name just a few, also where loans are granted to the buyer by the target company, where collateral is furnished by the target company on the purchasers behalf, or by way of a merger of the target company with the acquiring entity. No distribution triggering these consequences occurs however, where profits earned after the transaction are distributed, or where a dividend is paid out of capital contribution reserves (capital contribution principle).

In the context of share deals, the problem of indirect partial liquidation is often dealt with by distributing existing equity substance to the shareholders prior to the closing of the transaction. When doing this, however, attention should be paid to the statutory requirements for dividend distributions. Thus, for example, the admissibility of true interim dividends is controversial under prevailing Swiss law. In situations where a distribution prior to the transaction is not possible or not desirable, the seller will normally request that the buyer enters into a contractual commitment to refrain from taking any action, during the applicable five year period following completion of the transaction, that could give rise to a tax obligation on the part of the seller under the rules governing indirect partial liquidation and, where the buyer fails to keep that commitment, to fully indemnify the seller for any tax consequences suffered.

Transposition – Transfer of participation rights to a legal entity controlled by the transferor

"Transposition" is the term used in Swiss tax law for the transfer of privately held participation rights of 5 or more percent to a legal entity controlled by the transferring investor. Due to the fact that a shareholder transferring participation

In sales of shareholdings, clarity should be established without fail as to the tax consequences that will result from the sale both for the buyer and for the seller.

Stefan Wigger, MLaw, Certified Tax Expert

rights in the manner described still indirectly controls, through his stake in the acquiring entity, the participation rights, the Swiss Federal Supreme Court has decided that such a transaction does not constitute an alienation of the participation rights, but rather a restructuring of assets.

The tax consequences of a transposition can be mitigated either by transferring the shares to the controlled entity at their nominal value, or by choosing the "agio solution".

The qualifying criteria of control exercised by the transferring shareholder must be met only with respect to the legal entity to which the participation rights are being transferred. Accordingly, the qualification as a transposition may be triggered even where only a minority stake of 5 or more percent is transferred to an entity controlled by the shareholder. Conversely, the transfer of a majority stake to an entity which the transferring shareholder does not have control of, even after the transaction, does not constitute a transposition. The determinant factor therefore is the control over the entity to which the participation rights are being transferred.

The qualification of a transaction as a transposition entails tax consequences, however, only where the participation rights are transferred to the company under the shareholder's control at a price exceeding their nominal value plus the proportionate capital contribution reserves. In such case, the difference between the transfer value of the participations and their nominal value plus their capital contribution reserves will be taxed as income.

Where the difference between the market value and the nominal value is not credited to the shareholders' current account, but rather to other reserves (so-called "agio solution") the deferred tax burden will remain with the company's transferred reserves. Later dividends paid by the acquiring company out of those reserves constitute taxable income for the shareholder. The criteria for qualification as a transposition are thus not fulfilled.

FURTHER TAX ISSUES

Tax issues may arise not only when transferring shares to a buyer's business assets, but also when transferring them into his private portfolio. Some of the potential issues are highlighted in the following.

Factual liquidation (“Mantelhandel”)

The factual liquidation can be regarded as a direct partial liquidation. This results when the participation rights of a target company which does not exercise any activity at all, and whose assets are in liquid form, are sold. Without distributing the liquid funds and liquidating the company formally, the shareholder sells a shell company (“Mantelgesellschaft”) which economically is liquidated.

From a corporate law perspective, the transfer of a shell company may be void, since this transaction does not comply with the provisions governing the liquidation and subsequent reincorporation of a company. From a tax point of view, the corporation is considered as economically liquidated and subsequently reestablished. For the seller the realized tax-free capital gain will be re-qualified as taxable income in the amount of the fictitious liquidation dividend calculated as the sales price less the nominal value of the shares.

The purpose of this tax treatment is that a company that is brought to life again without the formal process of liquidation and reestablishment should not gain any tax advantages out of this transaction. Thus, in addition to the factual liquidation, from a tax point of view it must also be taken into account that the setting off of accrued losses carried forward from previous years against future profits is not permitted.

Sale of real estate companies

A special tax situation also may arise with regard to real estate companies. The term real estate company applies to any legal entity whose activities involve, exclusively or principally, the exploitation or use of real property (rentals, usufructuary leasing, sales, development, etc.). Operating companies, on the other hand, are interested in the long-term maintenance of their real estate property as a basis for their manufacturing, commercial, or other business operations.

With the sale of shares in a real estate company, the power to dispose over properties may be indirectly transferred without a change in legal title. Such a so-called "economic transfer of ownership" occurs where a controlling interest in a real estate company is transferred. Participations in a real estate company are considered as a controlling interest where

Every business owner occupies himself at some point with the question of succession. Early planning is the best way to ensure a successful changeover.

Natalie Peter, Attorney-at-Law, Dr. iur., LL.M., TEP

they represent, by themselves or in cooperation with third parties, a voting majority. The transfer of participation rights in operating companies is generally not treated as a taxable sale, even where the assets primarily consist of real estate.

The transfer of a majority interest in a real estate company is generally subject to cantonal and communal real estate capital gain tax and real estate transfer tax. The different practices and regulations in various cantons regarding the definition of an economic transfers of ownership and real estate companies and the taxation of real estate capital gains, trigger particular challenges.

The determination as to whether a transaction is qualified as personal asset management or as an activity of a self-employed professional is made taking into account the facts and circumstances of each individual case.

Professional securities traders

In practice the presumably tax-free capital gain will be re-qualified as taxable income where the securities traded are part of the business assets rather than the private assets of the seller.

Based on extensive Federal Supreme Court decisions regarding professional securities dealers, qualified self-employment, and thus business assets, must be assumed to be given if a taxpayer sells and purchases securities to an extent that exceeds the simple asset management of private assets. In other words, the seller conducts a professional business, meaning that the respective transactions are carried out on a regular basis with the intention to make a profit. A public presence, market participation, or a position in an organized business entity is not required for the assumption of professional status. It is not relevant whether the securities are managed and invested by a third party (bank, asset manager, etc.).

For the purposes of a preliminary examination, the Swiss Federal Tax Administration has defined five criteria, whose cumulative fulfillment results in the assumption that no professional securities dealership exists:

- The securities sold were held for a period of at least 6 months;
- The total of the sales and purchase prices do not exceed five times the amount of securities and deposits at the beginning of the tax period;
- The realized capital gains amount to less than 50% of net income achieved during the tax period;
- The investments are not leveraged;
- The purchase/sale of equity derivatives (e.g. options) is limited to hedges of the person's own securities positions.

If these criteria are not met in full, this may result in the assumption of self-employed professional activity, triggering income tax on realized capital gains. However, there still remains the possibility for the seller of demonstrating that his activities were not of a professional nature.

ISSUES TO BE CONSIDERED WITH REGARD TO INDIRECT TAXES

Indirect taxes play only a minor role in connection with share deals. Nevertheless, it is advisable to briefly consider indirect taxes in order to avoid unexpected tax consequences.

Securities transfer tax (Umsatzabgabe)

Share deals can be subject to securities transfer tax, if at least one of the contracting parties is considered a securities dealer. Individuals trading in shares for third parties, or brokering share deals as investment advisers or asset managers, may be considered as securities dealers.

Legal entities on the other hand qualify as securities dealers if their balance sheet shows, as a result of the share deal transaction, participation rights exceeding an amount of CHF 10 million. The securities dealer status not only triggers securities transfer tax liability but also entails reporting requirements vis-à-vis the Swiss Federal Tax Administration. It is therefore advisable to briefly review the situation.

"Old reserves" doctrine ("Altreservenpraxis")

Dividends paid by a Swiss subsidiary to its foreign parent are subject to Swiss withholding tax at 35%. The foreign parent may claim a refund according to the provisions of the applicable double taxation treaty. If the foreign parent sells the shares of the Swiss subsidiary to another legal entity and the dividend payment takes place after such sale, the tax authorities are likely to review the situation more closely in order to prevent treaty shopping. If the double taxation treaty between the jurisdiction of the buyer and Switzerland provides for a higher withholding tax refund than the double taxation treaty between the jurisdiction of the seller and Switzerland, the tax authorities are likely to allow only the refund applicable before such transaction.

This so called “old reserve” doctrine established by courts and tax authorities is only applicable if the tax authorities can establish the

use of an unusual legal structure or an abusive application of the double taxation treaty provisions.

Value Added Tax (VAT)

The sale of shares in a legal entity is explicitly exempt from VAT. As a consequence, no input tax reduction can be claimed for VAT paid on services connected with the share deal.

The share deal has no effect on the company's VAT status. If the company was a member of a VAT group, however, the buyer should keep the joint and several liabilities of the members of a VAT group in mind and take appropriate precautions.

CONCLUSION

The sale of a company by means of a share deal may, at first glance, appear to be simple but, depending on the specific circumstances, it can also have serious tax consequences. Hence, it is indispensable to closely examine the potential tax consequences a share deal may have for the buyer as well as for the seller. For the seller it is important to note that certain tax consequences may be triggered only consequent to a later transaction by the buyer. It is therefore important to stipulate appropriate warranties and tax indemnifications in the respective contract. §

Thomas M. Schmid, Stefan Wigger

The fundamental decision as to whether any future litigation that arises should be brought before a public court or referred to an arbitral tribunal must be made with care. The advantages and disadvantages of both alternatives must be weighed on a case-by-case basis.

Dominik Elmiger, Attorney-at-Law, M.A. HSG

Public court or arbitral tribunal?

Disputes following the conclusion of share purchase agreements are becoming increasingly common. The fundamental decision as to whether such disputes should be argued before a public court or an arbitral tribunal must be made carefully on a case-by-case basis.

FUNDAMENTAL DECISION

Disputes following the signing of share purchase agreements are becoming increasingly common, particularly disputes related to questions of warranty and price adjustment. It is common knowledge that when negotiating agreements, the parties involved frequently pay little attention to the possibility of such future disputes. Nevertheless, the fundamental decision as to whether disputes that may arise after a share purchase agreement is signed should be subject to public court or private arbitral tribunal jurisdiction must be made carefully. The advantages and disadvantages of both alternatives need to be considered on a case-by-case basis.

ADVANTAGES AND DISADVANTAGES OF PUBLIC COURTS VERSUS ARBITRAL TRIBUNALS

Regardless of whether jurisdiction lies with a public court or an arbitral tribunal, the location where any dispute should be resolved can be specified in a choice-of-court or arbitration clause. This is highly recommended, particularly in international agreements, since conducting litigation in one's own country and language offers significant advantages. If neither party wishes to give up the "home-court advantage", then an arbitration clause can also be used to stipulate a neutral venue in another country, which is more difficult or even impossible in the case of public court jurisdiction. A choice-of-court or arbitration clause must be edited carefully in order to prevent possible disputes over jurisdiction.

In an arbitration proceeding, the parties can freely select the arbitrators and thereby ensure subject matter expertise for the specific dispute. Public courts do not permit the selection of specific judges. Moreover, since the Swiss Code of Civil Procedure came into effect, it is no longer possible to stipulate the direct jurisdiction of a commercial court, in which specialized judges make decisions on commercial disputes. When public courts have jurisdiction, therefore, the parties have only limited opportunities to precisely determine the desired court. This clearly increases the importance of

the advantage offered by an arbitral tribunal, namely the ability of the parties to choose arbitrators with specific subject matter expertise.

Confidentiality in an arbitration proceeding can be ensured by inserting a nondisclosure clause in the share purchase agreement.

The parties generally have an interest in ensuring confidentiality when conducting litigation. Although the parties in a public court proceeding can exert only a limited amount of influence in this regard, confidentiality of proceedings can be ensured when an arbitral tribunal has jurisdiction. This generally requires an explicit nondisclosure clause, however, which can be integrated into the share purchase agreement itself.

The most important advantage of arbitral jurisdiction lies in the flexibility it provides for structuring the proceeding. As a rule, the parties are completely free to specify both the organization of the proceedings and the composition of the arbitral tribunal ("ad hoc arbitration"). By contrast, public court procedures are strictly regulated. It should also be noted here, however, that in arbitral tribunals supervised by an arbitration institution such as the Zurich Chamber of Commerce or the International Chamber of Commerce, the applicable procedural rules are similar to those of the courts in terms of the level of detail. Another aspect closely related to flexibility is the duration of a proceeding. Depending upon the procedural rules chosen, a dispute can be resolved more quickly in an arbitral proceeding than in a public court. It should be noted, however, that in contrast to public courts, private arbitral tribunals do not have the same capacity to enforce their own decisions. They depend in any case upon the support of the public courts, for example when ordering interlocutory measures, summoning witnesses, or enforcing an arbitration decision. If one party to the arbitration is determined to disrupt the course of the proceeding, this can lead to significant delays. Opportunities to challenge decisions also have a significant influence on the duration of a proceeding.

In arbitral jurisdiction, the parties are completely free in principle to specify the organization of the proceedings as well as the composition of the arbitral tribunal.

There are significant differences between the options for challenging decisions of public courts as compared to challenging decisions of arbitral tribunals. In the event of public court jurisdiction, if the dispute was not heard by a commercial court, then the losing party will generally have two avenues of appeal in litigation involving share purchase agreements. In

The sale of a company by means of a share deal may, at first glance, appear to be simple but, depending on the specific circumstances, it can also have serious tax consequences. Working as a team, the lawyers at Staiger, Schwald & Partner are able to guide their clients through the maze of company and tax law surrounding company sales and help them avoid pitfalls before they arise.

an arbitration proceeding, there is generally only one avenue of appeal, and the options for challenges are extremely limited. Each party must decide based upon its own interests wheter this is an advantage or disadvantage.

Finally, once a definitive decision has been made, there is the question of its recognition and enforcement. Here it is essential to establish whether the country in which a ruling is to be enforced is a signatory state to the New York Convention. If this is not the case, then public court jurisdiction is generally preferred, since decisions by public courts are usually easier to enforce.

With respect to costs, the parties must ultimately decide on a case-by-case basis which of the two alternatives offers a cost advantage. In doing so, they must consider the fact that the public courts are subsidized by taxes, and litigation in such courts therefore tends to be less expensive. However, there is some disagreement as to whether this also applies in the case of complex litigation. §

Dominik Elmiger