Memorandum

To
Interested Parties

From
Peter Reinarz, Bär & Karrer, Zurich

Date
Zurich, 29 January 2004

Re
Important Swiss Tax Court Decision

The Federal Supreme Court has recently (on 6 January 2004) rendered a ruling in the field of federal corporate income taxes, which is quite significant for international groups with corporate operations and especially holding company functions carried out in Switzerland.

The Supreme Court ruling deals with the application of the "participation relief" to capital gains realized by a Swiss corporate entity upon the sale of a substantial holding of shares in another company. The Corporate Tax Reform of 1997 has introduced the application of the participation relief to capital gains realized on substantial investments. Prior to the reform, participation relief was only applicable to dividends from shareholdings representing either a stake of at least 20% in the underlying company or a fair market value of at least CHF 2,000,000. The reform extended the participation relief to capital gains on corporate investments that were held for at least one year and represent an interest of at least 20% in the capital of the underlying company. Under the transition rules of the Reform Act, the immediate extension of the participation relief to capital gains on substantial equity investments is essentially limited to those investments which were acquired by the Swiss company after 1996 ("new investments"), whilst the application of the participation relief to capital gains on "old investments" (investments acquired before 1.1.1997) is only applicable if the capital gain from a sale occurs on or after 1.1.2007.

Art. 207a par. 3 Direct Federal Tax Act ("DFTA") contains an important exception to this general transitional rule. That provision contains a favourable rule concerning cross-border re-structurings of corporate investments. It basically provides that, if a Swiss company transfers an "old investments" representing at least 20% of the share capital of an underlying company to a foreign company belonging to the same group, such transfer is deemed to be made at the fair market value of the investment being transferred and the

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difference between the market value and the book value for income tax purposes is included in the taxable net income. However, the Swiss company may neutralise the resulting capital gain by creating a tax-deductible reserve in the amount of the capital gain. Such reserve must be realised into taxable profit if and when the foreign transferee company sells the investment to an unrelated third party, or if the company, the shares of which have been transferred disposes of its assets and liabilities to a substantial extent or when it is liquidated. In the event that no such sale to a third party occurs by 31.12.2006, the tax-free reserve will automatically be released without any further income tax consequences.

In its Circular Letter no. 10 dated 10 July 1998, the Federal Tax Administration ("FTA") had given its interpretation of the notion "foreign group company" used in Art. 207a par. 3 DFTA. The FTA took the view that said provision was applicable only to transfers of "old investments" by a Swiss company to a foreign incorporated company, the capital of which was effectively controlled by the Swiss transferor company or by another Swiss resident entity belonging to the same group of companies. "Control" would generally mean a shareholding in excess of 50%. According to the approach taken by the FTA, it was, therefore, not possible to use the tax-free reserve solution in the event of a transfer of "old investments" to either a foreign parent company or a foreign sister company.

The Federal Supreme Court has now rejected that restrictive position. The Supreme Court has held that the restrictive approach to limit the tax-free reserve solution to transfers to foreign group companies which are effectively under the control of the transferring Swiss company or another Swiss company related to the Swiss transferor is not compatible with either the literal text, the history, or the general objective of the statute and the company tax reform generally. A main objective of the company tax reform was to increase the attraction of Switzerland as a location for international holding companies. The critical provision was to ensure that, while under the transition rules the effect of the reform on "old investments" would be deferred until the year 2007, such deferral in respect of "old participations" was to be avoided where an investment transfer to a foreign transferee was effectively made in the context of a group-internal restructuring. It was not the intention of the legislator to limit the benefits of a tax-neutral restructuring of old investments to those foreign transferee entities, which are under the control of the Swiss transferor. Instead, any foreign transferee entity that is under the same corporate control as the Swiss transferor entity is eligible for the tax-free reserve solution. Hence, the tax-free reserve solution can also be used to transfer substantial "old investments" during the transition period to any foreign parent or sister company in a tax-neutral manner; the capital gain would only be taxed if and when the transferred investment is sold by the foreign transferee company to an unrelated third party, or legally or factually liquidated prior to 1.1.2007. If no such events occur until 31.12.2006, the tax neutrality of the transfer will become final.

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