Have you ever heard about the Swiss "old reserves practice"?

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Abstract

- **If you acquire a participation in a Swiss company, then you must consider the "old reserves practice." The old reserves practice might limit your ability to get relief from Swiss dividend withholding tax.**
- **The old reserves practice applies if you have better access to relief from Swiss dividend withholding tax (e.g., a better double tax treaty rate) than the previous shareholder transferring the shares to you. In such a situation, before you acquire the Swiss company shares, you must check if there are "old reserves" in the Swiss company.**
- **The reason is because with the acquisition of the Swiss company shares, you acquire tainted "old reserves": The less beneficial withholding tax relief rules, as applied to the previous shareholder who transferred the Swiss shares to you, will continue to apply once the old reserves are distributed to you as the new shareholder.**
- **"Old reserves" are any funds eligible for distribution under Swiss corporate law, which are also not necessary for the Swiss company's operational purposes at the time you acquire the Swiss company shares.**
- **An advance tax ruling can be obtained from the Swiss tax authorities to set the amount of the old reserves and to get legal certainty regarding future dividend distributions. This advance tax ruling will allow you to price in the latent dividend withholding tax burden taken over on the old reserves when making your offer for the Swiss company shares.**

What is the "old reserves practice"?

The old reserves practice relates to the rules for relief from Swiss dividend withholding tax on cross-border dividend distributions: The old reserves practice addresses situations where the current non-Swiss shareholder is either not entitled to relief from Swiss dividend withholding tax at all, or only partially entitled to such tax relief (because of a double tax treaty not providing for full tax relief but for a residual withholding tax burden).

In such a situation, a transfer of the Swiss shares from shareholder A in country A to shareholder B in country B can result in a situation where, after the transfer of the shares, shareholder B has better access to relief from Swiss dividend withholding tax. For example, the Swiss double tax treaty with country B might provide for full relief from dividend withholding tax, whereas the treaty with country A does not.

For these kinds of transactions, the Swiss Federal Tax Administration ("Swiss FTA") may claim that the transfer of undistributed reserves in the Swiss company constitutes an abusive arrangement, thereby evoking application of the so called "old reserves practice."

Example:

Under the Swiss/US double tax treaty, the best case scenario for dividend withholding tax relief normally is a 5% residual withholding tax burden. If the US shareholder transfers his Swiss participation to a legal entity in, for example, the Netherlands, the residual Swiss dividend withholding tax may be reduced to nil. The reason is because, after the transfer, the Swiss/Dutch double tax treaty applies, which brings with it rules more beneficial for withholding tax relief.

What happens if "old reserves" are established?

If "old reserves" exist when the Swiss shares are transferred, and once these old reserves are distributed to the new shareholder, application of the more beneficial dividend withholding tax rules, which generally apply to the new shareholder, will be disallowed on the old reserves.

The Swiss FTA applies to the distribution of old reserves the withholding tax rate/relief rules applicable prior to the transfer of the Swiss shares. As a result, the earlier, less beneficial, double tax treaty relief rates, or no double tax treaty relief at all, will apply.

Thus, the old reserves practice hits the new shareholder. Accordingly, if you buy a Swiss com-pany, you want to know the amount of "tainted" old reserves and price in the corresponding latent withholding tax burden.

The same old reserves practice also applies if there is a transfer of the registered office of the Swiss company's parent company from country A to country B, resulting in an improvement in the dividend withholding tax relief rules.

The old reserves practice will not be applied if there is a change in the legal situation without a change to the shareholding structure: for example, if the rules of an existing double tax treaty are changed such that tax treaty provisions providing for a residual final tax burden are replaced with a new 0%-rate regime.

How is the old reserves practice justified?

In the case of a group-internal reorganization, the tax authorities often assume that the main purpose of a group-internal reorganization is to get better access to relief from Swiss dividend with-holding tax, and that therefore there is no true business reason for the reorganization.

Here too, if there is a sale to an independent third party, the tax authorities often assume that the seller, before the sale, should have paid out all the funds not essential for the company's opera-tional purposes as dividends because the buyer would have no interest in unnecessary cash flows that would increase the sale price. In extreme cases, sellers do not pay any dividends for years, for tax reasons, as they are reckoning on a buyer with better access to tax relief.

How is the amount of the old reserves decided?

Old reserves are any funds eligible for distribution under Swiss corporate law, and which are also not necessary for a Swiss company's operational purposes at the time of the reorganization or sale.

To establish the amount of the old reserves, the lower of the following amounts is decisive:

- freely distributable reserves according to Swiss corporate law, based on the last relevant financial reporting date (liabilities side); or
- funds not necessary for the Swiss company's operational purposes (assets side).

In terms of what are "freely distributable reserves," according to Swiss corporate law, commonly decisive are the book values from the last statutory stand-alone financial statements before the reorganization/sale. The values on the tax accounts are irrelevant. Switzerland has mandatory corporate law capital protection rules, i.e., freely distributable reserves are determined as follows: total equity less statutory share capital less statutory reserves, to the extent such reserves cannot be transferred into unrestricted, distributable reserves (20% respectively 50% of the share capital). The deduction for the legal reserves from the total equity is recognized, regardless of the actual amount. In addition, for purposes of the old reserves practice, qualifying capital contributions reserves are deducted because these are exempt from dividend withholding tax anyway.

"Funds not necessary for operational purposes" are any funds that the Swiss company does not need in order to fulfill its commercial objectives. The determination of the non-operational funds is based on the funds available at the time of the reorganization or sale.

The extent of the funds not necessary for operational purposes will be determined on a consolidated basis, which generally includes the reserves of group companies that are legally available for distribution, where the Swiss company can decide on the distribution policy.

Loans to affiliated companies, especially if to a (direct or indirect) parent company, are generally considered to be funds not necessary for operational purposes. The Swiss FTA's argument is that the Swiss company granting the loan does not have any financial duty towards the parent company; a case-by-case evaluation takes place in this situation.

Ultimately, it can be concluded that the maximum amount of old reserves is capped at the amount of reserves that were legally eligible for distribution as a dividend under Swiss corporate law.

When are funds "necessary for operational purposes" of a business?

The decision about what is actually legally eligible for distribution can be made relatively easily. Conversely, the difficult question is when, and to what extent, funds qualify as necessary for operation. To establish the amount of business-essential funds, a case-by-case evaluation is necessary.

Funds that are needed for future investments such as approved research projects, the construction of a laboratory for a subsidiary, the acquisition of an equity investment, etc. are generally accepted as necessary funds for operation. Concrete proof, however, must be provided; for example, previously signed contracts that can justify the company’s liquidity requirements. It is not enough to have a general intention to make investments in the future should an opportunity arise. Evidence in the form of cash flow calculations can be helpful if they prove that a company, based on its activities during the business year, has a different, high requirement for business-essential funds (for example seasonal fluctuations).

What can be done in the case of a reorganization or sale?

The old reserves practice hits the new shareholder. Accordingly, if you buy a Swiss company, you want to know the amount of "tainted" old reserves and price in the corresponding latent withholding tax burden.

An advance tax ruling should be obtained from the Swiss FTA. In the ruling procedure with the Swiss FTA, the amount of the old reserves can be set, and then there is legal certainty regarding the future dividend distributions.

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