Dear Reader,

This Newsletter turns the spotlight on strategies to prevent base erosion and profit shifting (“BEPS”): the EU estimates that BEPS is costing its member states some EUR 1 trillion a year in lost revenue. Various international bodies are devising ways of combating avoidance through profit shifting, a practice that could significantly affect Switzerland, given its attraction as a location for multinationals.

This issue also provides details of a Swiss Federal Supreme Court decision rejecting offshore financing for Swiss real estate groups. The written grounds for the decision, which are now available, are highly relevant to the practical implementation of the decision.

A decision by the Federal Supreme Court a year ago heralded more liberal practice by the tax authorities in future with regard to transfers of prior-year losses from target companies as part of a merger. We now report on further rulings by the Federal Supreme Court which indicate that the authorities will continue to take a restrictive approach.
Collective Investment Schemes Ordinance and their implications for the VAT treatment of supplies in relation to collective investment schemes, new VAT practice concerning the distinction between VAT-exempt and taxable supplies of real property, and the adoption of “minor” corporate tax reforms with new rules on fiscal entities in Germany.

And finally, as last year, this Newsletter also brings you the latest news from the cantons. We hope you will find this issue an interesting and enjoyable read.

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Various international bodies, such as the OECD, the EU and the United Nations, have launched projects aimed at devising ways of combating tax avoidance through profit shifting and the erosion of the tax base as practised by multinational enterprises. In this connection the media spotlight is currently focusing for example on Starbucks, Amazon, Google, Apple and Nissan. It is reported that they have apparently paid little or no tax in certain countries, despite making group-wide profits. The EU estimates that tax avoidance and tax evasion cost its member states appr. EUR 1 trillion tax revenue per year. Switzerland, being an attractive location for businesses, could be one country impacted by actions against BEPS.

The OECD (Organisation for Economic Cooperation and Development), like the European Union and the United Nations, is looking for measures to stop the so-called “tax avoidance” of multinational enterprises. In this connection the European Commission published an Action Plan and two recommendations under the headings “Recommendation on aggressive tax planning” and “Recommendation on tax havens” on 6 December 2012. As part of the OECD project regarding the shifting of profits and the erosion of the tax base (“Base Erosion and Profit Shifting” or “BEPS”), the OECD is exploring whether, and if so why, multinational enterprises can move their profits to other countries under the current rules. On 12 February 2013 the OECD released a first interim report, which focuses on the following key pressure areas:

- Mismatches in entity and instrument characterization (hybrids and arbitrage);
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- Related-party debt-financing, captive insurance, and other intra-group financing;
- Transfer pricing, in particular in relation to the shifting of risk and intangibles, the artificial splitting of ownership of assets between group legal entities, and group transactions that would rarely take place between independent entities;
- The effectiveness of anti-avoidance measures - such as GAARs, CFC, thin capitalization rules, and rules to prevent treaty abuse;
- The availability of harmful preferential regimes.

The interim report recommends developing a comprehensive action plan by June of this year which will identify specific actions, set deadlines for implementation, and identify the resources needed to go forward. The plan should be adopted at the next meeting of the OECD’s Committee on Fiscal Affairs in June 2013.

The OECD’s interim report will serve as the basis for future discussions at the forthcoming G-20 meetings in 2013. From a Swiss perspective it is essential that the international tax competition should not be impaired; Furthermore, discussions on BEPS should also address the tax practices of certain “major” states as well as direct and indirect subsidies, which have not yet been addressed by the OECD. One will wait with bated breath to see which position the Swiss finance minister, Mrs Eveline Widmer-Schlumpf, will take in the future in this regard.

Base Erosion and Profit Shifting (“BEPS”)

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On 5 October 2012, the Federal Supreme Court had to judge on the tax recognition of offshore financing for purely Swiss corporate groups. The facts and reasoning relating to the public hearing were subject to an initial critical analysis in our December 2012 Tax News. The written considerations for the decision, which have now been published, are of high importance with respect to the practice. The newsletter at hand will highlight this in more detail.

Applicable definition of “permanent establishment” and requirement of substance
In passing its judgment, the Federal Supreme Court addressed the requirements placed on a permanent establishment abroad belonging to a Swiss company. In principle, a “permanent establishment” is a fixed place of business through which all or some of a company’s business activities are carried out. The Swiss Federal Supreme Court ruled in line with the prevailing doctrine, stating that the definition of a “permanent establishment” should be interpreted identically with respect to both a permanent establishment abroad belonging to a Swiss company and a permanent establishment in Switzerland belonging to a foreign company. However, despite this requirement for equal treatment, the Swiss Federal Supreme Court ruled that Swiss companies in Switzerland have an unlimited tax liability and as a result unilateral rules under which double taxation can be avoided, should tend to be interpreted somewhat more in favor of Switzerland’s right of taxation. As such, the Swiss Federal Supreme Court places stricter requirements on permanent establishments abroad than on permanent establishments in Switzerland, which tends to lead to an increased right of taxation in Switzerland.

In the case at hand, the Swiss Federal Supreme Court upheld the existence of a fixed place of business, but rejected the argument that some business activities were carried out there. With respect to the substance of the permanent establishment, the Federal Supreme Court justified this rejection by arguing that the financing company employed only 4 people (with a combined headcount of 0.8) and that such a lean structure was in obvious contrast to the figures in the annual financial statements. As such, the Swiss Federal Supreme Court declared that it was not clear to what extent the establishments on the Cayman Islands added any specific value. In this respect, the Swiss Federal Supreme Court stated that it was hardly the intention of the legislator to allow auxiliary functions to be located in a low-tax country so that taxable basis can be fully allocated in a manner that is to the detriment of Switzerland, and which leads to a company being largely exempt from any applicable corporate income tax.

Background and current situation
As already discussed in our December 2012 Tax News, a number of purely Swiss corporate groups managed their internal financing through financing companies in offshore countries. To enable such financing, a subsidiary was usually established offshore, funded primarily by equity from the Swiss parent company. The net financial income generated by the subsidiary through its financing activities would remain de facto untaxed income due to the lack of corporate income tax abroad, the absence of withholding tax on dividends paid to Switzerland, and the participation exemption in Switzerland.

The Federal Supreme Court had to pass judgment on a similar case, where a Swiss group had its group financing activities performed by a permanent establishment of the Swiss financing company based in the Cayman Islands, which had its own premises and engaged four employees each working part-time of 20%. A tax ruling with the Cantonal Tax Administration where the group was domiciled attributed the income earned from financing activities wholly to its permanent establishment in the Cayman Islands, which unilaterally made such earnings exempt from Swiss taxes. Based on the applicable law in the Cayman Islands, the interest income was also not subject to any taxation in the Cayman Islands. The Swiss Federal Tax Administration (SFTA) declared that the tax ruling would no longer be recognized in respect of direct federal tax. Ultimately the Swiss Federal Supreme Court was required to judge on the disputed assessment notice.

Even if there is some comprehension for this decision in relation to pure domestic Swiss relations, the justification for it is seen as less than convincing. In particular, the Swiss Federal Supreme Court did not address the issue of what the business activities of a financing company actually comprise, but instead decided goal-oriented that the employees in the case examined were merely performing auxiliary services. Even the lack of any additional such activities being performed in Switzerland did not lend any weight in favor of the activities in the Cayman Islands.

In issuing such a decision, the Swiss Federal Supreme Court could have been expected to investigate the key argument relating to the lack of substance in greater detail. However, this decision clearly demonstrated that in future, offshore financing relating to pure domestic Swiss relations will increasingly be questioned. The extension of this decision at an international level would require a more substantial justification, since profits not subject to tax abroad could not automatically be allocated to Switzerland for taxation.

U-turn over legitimate expectations of tax rulings
Finally the Federal Supreme Court referred the issue of whether the financing company can invoke the issue of
legitimate expectations back to the court of lower instance, instructing it to address the issue of the binding effect of the tax ruling for the SFTA in particular. It went on to state that it was unclear whether the SFTA had been involved in the ruling process; this would have a direct impact on taxpayers’ legitimate expectations with regard to the SFTA. If the SFTA had been involved, it would be necessary to examine whether retroactively annulling the ruling of 1 January 2005 would be in breach of the bona fide principle.

If there were only legitimate expectations on the part of the taxpayer with regard to direct federal tax when the SFTA was involved in the ruling process, this would represent a clear move away from the current standard practice when giving rulings. Under current legal doctrine, cantonal and SFTA practice as well as the jurisdiction of courts at all levels, to date the cantonal tax authorities, as the legally authorized assessment authorities, have been responsible for issuing rulings with respect to direct federal tax. It remains to be seen how this decision will impact standard practice on rulings. In any case, any break with the previous standard practice on rulings would represent a legally questionable restriction of the cantons’ authority. Ultimately, this change would mean the loss of a significant advantage offered by Switzerland as a financial and tax location, as the previous system guaranteed great flexibility for all parties, even in urgent cases.

BGE of 5 October 2012, 2C_708/2011

Forfeiture of tax losses in company mergers

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Further rulings by the Swiss Federal Supreme Court Indicate a continuation of restrictive practice

Background

The Federal Supreme Court’s ruling on 4 January 2012 (2C_351/2011), which approved the transfer of tax losses in a company merger, was widely welcomed as heralding a more liberal practice in the future. It was discussed in depth in an article by Staehlin/Brahier in our June 2012 Tax News.

In the ruling, the Federal Supreme Court repudiated the former requirement that the tax losses had to be part of an operating business that was transferred to and continued within the acquiring company. What was called for instead, it said, was precise conditions to disallow, under exceptional circumstances, the transfer of hidden reserves and tax losses. Such exceptional circumstances would occur, for example, if there were no practical or business reasons for the restructuring whereas the mere creation of possibilities to deduct tax losses was not to be seen as one. Under such conditions, it was not appropriate to take a static perspective, focusing on the continuation of the operating business, when what was needed instead was a dynamic analysis focused on the continued economic existence of the company that had been taken over.

According to the ruling, it was also of crucial significance that non-capitalized intangible assets (including know-how and the client database) were transferred, as these increased the turnover of the acquiring company, and such an increase in turnover was a significant indicator that the merger made business sense.

Since early January 2012, the Federal Supreme Court has had the opportunity, in three further rulings, to state a position on the transfer of tax losses in company mergers, and these indicate that the ruling of 4 January 2012 was not, as some tax advisors erroneously thought, to be understood as a “free pass” for the untrammeled use of tax losses carried forward in mergers for the purpose of gaining tax relief.


In these rulings, which primarily concerned the tax deductibility of recapitalization costs at the level of the parent company, the Federal Supreme Court, expressed by way of an obiter dictum in para. 6.2.2, a view on the question of the transfer of tax losses in the course of an absorption of a subsidiary. However, the final assessment of the actual case was referred back to the tax administration of the canton of Zug for the purpose of ascertaining new elements of fact and handing down a new order.

In so doing, the Federal Supreme Court ruled out a transfer of tax losses insofar as the absorbed subsidiary was an “empty shell” that actually should have been liquidated. The specific question it addressed was whether the subsidiary, at the time of its absorption, was still engaged in serious contract R&D for the benefit of its immediate parent. If this question could be answered in the affirmative, the deduction of tax losses at the level of the absorbing parent company was permissible; otherwise, it was not.

Ruling 2C_85/2012 of 6 September 2012

A. AG, a company based in the canton of Thurgau, originally had three different divisions operating in the weaving business. One division was spun off to a newly founded sister company in 2002, a second was closed down in 2003, and the third was transferred to a subsidiary with effect from mid-2005. A. AG was then – with effect from 30 June 2006 – absorbed by the parent company, which was based in the canton of Zurich. At the time A. AG was absorbed, 94.9% of its assets consisted of (rented-out) real estate, which, according to the ruling, did not qualify as a business operation.

In this specific case, the Federal Supreme Court did not allow the deduction of the tax losses carried forward by A. AG at the level of the absorbing parent company. It justified this ruling by pointing to the
absence of even minimal business activity or of any plausible commercial reasons for the merger. An additional, and aggravating, consideration was that it was stated, in internal email correspondence within the complainant company, that "the added loss carryforwards would make it possible to disclose hidden reserves of something like CHF ... on the securities portfolio without any tax implications".

**Ruling 2C_701/2012 of 24 November 2012**
The subject of this ruling is an investment company in the medical technology sector that was formerly listed on the Swiss stock exchange. It was acquired by a Swiss bank group, whereupon all the holdings were sold to an investment fund under Luxembourg law up until March 2008, when the investment company, which had carried forward tax losses of some CHF 75 million, now had only liquid assets on its balance sheet and was taken over by way of merger (retroactively to 30 June 2008) with a sister company at the end of November 2008. The liquid assets were used to buy further holdings in the summer of 2009.

The Federal Supreme Court disallowed the deduction of the tax losses carried forward – which amounted to some CHF 75 million – at the level of the absorbing sister company, expressing the view that there were no evident commercial reasons for the merger, even if, for the purpose of simplifying the group structure it certainly made sense to cause the former investment company to be absorbed by its sister. As only cash resources were transferred as a consequence of the merger, minimal economic continuity was absolutely impossible. Whilst the reinvestment of the cash in new holdings might well constitute a dynamic course of action, it also conclusively demonstrated that economic continuity could not be in view. Were this requirement able to be met by the mere transfer of liquid funds, it would be deprived of any substance whatever.

**Summary**
What the rulings cited above show is that the Federal Supreme Court, by its ruling of 4 January 2012, did not open the way to the unconditional transfer of tax loss carry-forwards in mergers, but rather that every individual case still needs to be considered separately and on the basis of the specific facts. The Federal Supreme Court will continue to focus on the presence of minimal economic continuity (even if no longer in the form of an operating business) while demanding much of the criterion of the merger's commercial rationale.

It remains to be seen how the tax authorities will implement these stipulations in their day-to-day practice. It can be assumed, though, that the transfer of tax losses in company mergers will still be accepted only with some reservations.
Federal Supreme Court of Switzerland widens the scope of the Tax Savings Agreement in respect of foreign companies

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The guidelines issued by the Swiss Federal Tax Administration (SFTA) on the Tax Savings Agreement (TSA) state that foreign cooperatives and some other companies under foreign law cannot avail themselves of the Agreement’s provisions and must therefore rely on a double taxation agreement if the reclaim of the withholding tax paid on dividends distributed by Swiss companies is intended. The Federal Supreme Court has decided in a leading case that the SFTA’s guidance on this issue is itself in breach of the Agreement.

Consideration of the Federal Supreme Court
Regarding the qualification as a limited company, the Federal Supreme Court has, in its recent decision BGE 2C_176/2012 of 18 October 2012, stated that cipher 9 (b) of the guideline on the Tax Savings Agreement is in breach of the Agreement and that foreign cooperatives and other companies under foreign law could not automatically be denied the right to enjoy the benefit of art.15 para. 1 TSA. The case judged by the Federal Supreme Court concerned a public limited liability company that had paid out a dividend to the parent company, its single shareholder, which was an Italian company in the legal form of a cooperative with capital divided in shares.

In its ruling, the Federal Supreme Court stated that art.15 TSA is based on the EU’s Parent-Subsidiary Directive, in the annex to which the EU listed those legal forms in each of its member states that qualify within the meaning of the directive as capital companies. As the cooperative under Italian law was among them, full exemption from withholding tax was to be given. In the case of those legal forms that were not exactly specified in the same annex, it would have to be examined whether the Parent-Subsidiary Directive had been transposed into domestic law and whether the legal form in question - in the case at hand that of a cooperative with capital divided in shares - was regarded as a capital company under the law of the member state in which it was domiciled. If this were the case such a company could rely on the Parent-Subsidiary Directive as well.

The SFTA contradicts the sense of the agreement by regarding foreign cooperatives and other foreign legal forms per se as not being capital companies within the meaning of art. 15 para. 1 TSA. Consequently it is not permissible to unilaterally exclude them from the scope of application.

Scope of application of the Tax Savings Agreement and Swiss Federal Tax Administration practice
One of the purposes of the Tax Savings Agreement between Switzerland and the member states of the EU is to exempt completely from withholding tax on income from dividends and interest as well as royalties from affiliated companies. According to art. 15 para. 1 of the Agreement, dividends paid by a subsidiary to a parent company may not be taxed in the source country if they cumulatively fulfill the conditions set out in it. Among others, these are (i) that the parent company must, as a rule, have owned for at least two years a direct holding of 25% in minimum of the capital of the subsidiary, and (ii) that both are in the form of a capital company.

The conditions for the exemption of interest and royalties from withholding tax are similar. The contracting parties elucidated the second criterion of Art.15 TSA - that of both companies being capital companies - in a footnote stating that, as far as Switzerland was concerned, the term «capital company» embraced the public limited liability company, the limited liability company and the limited partnership by shares. The Agreement did not specify which legal forms in EU member states qualify as capital companies. In its guidelines on the Tax Savings, the SFTA stated that the EU member states were to assume, as a working hypothesis until further notice that these were the legal forms listed in the annex to the EU’s Parent-Subsidiary Directive. This includes however, cooperatives, public corporations and institutions as well as partnerships, which are not recognized as limited companies and are therefore not covered by art. 15 para. 1 of the TSA.

Implications in practice
Several of the double taxation agreements between Switzerland and EU member states provide - or provided - no complete relief from Swiss withholding tax in the situations specified above. It would appear to be possible now to reclaim the withholding tax completely provided the parent company is a foreign cooperative or is one of the legal forms listed in the annex to the EU’s Parent-Subsidiary Directive. Where that is the case and dividends have already been distributed, it needs to be examined whether the withholding tax can be reclaimed completely on the basis of art. 15 para. 1 TSA at this time.

With dividend payments in the future, the notification procedure should be requested from the SFTA by using form 823 C. As soon as an approval of the SFTA has been given, a distribution of dividends can be reported by using form 108 (and the other forms referred to in it). If the distribution is reported in due form and on time, it no longer should be necessary to pay the withholding tax and after reclaim it.
The revision of the Swiss Federal Collective Investment Schemes Act (CISA) and its tax effects

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In the autumn session 2012, the Swiss parliament adopted the partly revised Collective Investment Schemes Act (CISA) and the Federal Council has agreed on the Ordinance on Collective Investment Schemes (CISO) on 13 February 2013, which implements the revised CISA. Both decrees entered into force on 1 March 2013. Together with the revised CISA, also the revised exemption of Art. 21 Para. 2 Ciph. 19 lit. f VATA enters into force.

This change influences also the VAT treatment of services, which are provided in connection with collective investment schemes.

With the implementation of the revised CISA and the revised CISO (revCISA/revCISO) on 1 March 2013, also a revised Art. 21 Para. 2 Ciph. 19 lit. f VATA entered into force. The revised VATA now explicitly mentions that the distribution of collective investment schemes is a tax exempt turnover without credit according to Art. 3 Para. 1 revCISA.

Art. 3 Para. 1 revCISA defines the distribution of domestic and international collective investment schemes and newly separates between (a) the distribution to qualified investors and (b) the distribution to non-qualified investors. Art. 3 Para. 2 revCISA defines the activities, which do not qualify as distribution activities.

While the distribution to non-qualified investors in Switzerland requires a distribution authorization for the foreign collective investment scheme from the Swiss Financial Market Supervisory Authority (FINMA), the distribution to non-qualified investors in Switzerland is still not subject to an authorization from FINMA. It is now however necessary, that a representative and a paying agent are appointed. Accordingly, Art. 2 Para. 1 lit. b in connection with Art. 120 revCISA regulate, that all foreign collective investment schemes, which will be sold to non-qualified investors in Switzerland are subject to the revCISA.

Since the term „distribution to a non-qualified investor“ just replaces the term “public distribution”, which was used in the old CISA, it can be expected that – since the requirement for the regulatory approval does not change - also the VAT treatment in this respect will not change. It is however not clear, how the VAT treatment of the (newly required) representative of the foreign collective investments schemes will look like.

New is the explicit reference in Art. 21 Para. 2 Ciph. 19 lit. f VATA that activities according to Art. 3 Para. 2 revCISA - contrary to the previous law - are seen as tax exempt services without credit. These are the provision of information with regard to collective investment schemes and the acquisition of collective investment schemes in the context of (a) consultancy contracts according to Art. 3 Para. 2 lit. a in connection with Art. 3 Para. 3 CISO and/or on the own initiative of the investor (execution-only), (b) in the context of a written asset management agreement with a supervised financial intermediary according to Art. 10 Para. 3 lit. a CISA and (c) in the context of a written asset management agreement with an independent asset manager. If and how far the new Art. 21 Para. 2 Ciph. 19 lit. f VATA will enlarge the area of services, which are treated as tax exempt without credit in the practice, remains to be clarified.

Furthermore, the Swiss Federal Tax Administration (SFTA) has announced that with the publication of the revCISA they will also reconsider the VAT treatment of asset management services. However, the SFTA did not yet express an opinion with regard to this topic.

The revision of the CISA partly also has influence on direct tax. With the new regulatory direction organization, distribution system and possible compensatory payments can be revised and eventually be amended.

We therefore recommend that the treatment of all services which could be subject to the described revision should be reassessed in detail and - if needed - to require the SFTA to confirm existing indirect and direct tax rulings.

1 With the exception of the new legislations with regard to the qualified investors, to the Key Investor Information Document (KIID) and with regard to the mandatory records in the context of the codes of conduct.
New VAT practice: Distinction between VAT exempt without credit and taxable supply of real estate

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The practice of the VAT Department of the Swiss Federal Tax Administration (SFTA) for differentiating between (taxable) supplies and (tax exempt) supplies of real estate under the new Value Added Tax Act (VATA) was controversial from the outset. The SFTA is changing its practice in this regard retroactively to 1 January 2013. The option of applying either practice will be available until 30 June 2013, but the new practice must be applied from 1 July 2013.

Under current VAT practice, a VAT exempt supply of real estate is made if the land belongs to the developer (total contractor, investor) or a related party and the following conditions have all been satisfied collectively:

- The purchaser acquires an off-plan real estate.
- A fixed price is agreed for land and building.
- The buyer’s influence is limited and extra costs arising through individual requests for modifications amount to no more than 5% per property (or 7% if land has building rights).
- There is one purchase agreement for the land and building between general contractor/investor and buyer.
- Benefit and risk are transferred only after the building works have been completed.
- Payment is made only after the building works have been completed (advance payment of up to 30% is not prejudicial for qualification).

If not all of these conditions have been satisfied, the transaction is classified as a taxable supply subject to the ordinary rate of currently 8%.

In practice, the criterion of the “buyer’s limited influence” has proved to be particularly problematic. If individual requests for modifications exceed the aforementioned percentage threshold, the VAT qualification changes during the construction process and the VAT treatment of the transaction accordingly.

The SFTA published the second and final draft of the future practice on 20 February 2013.

VAT practice Info 05
Under the new practice, the commencement of construction will again be crucial, as it was under the old Value Added Tax Act.

The sale of a real estate on which the seller is building a new construction or on which a refurbishment is being carried out, with the relevant sale or purchase contract concluded pursuant to Article 216 paras.1 and 2 of the Swiss Code of Obligations and/or a service contract concluded pursuant to Article 363 of the Swiss Code of Obligations before construction commences is classified as a taxable supply of real estate. In all other cases, the transaction is classified as a tax exempt without credit supply of real estate. It should be noted that a supply of real estate cannot be tax exempt without credit if the land belongs to the “buyer” or a third party.

The commencement of construction is always defined for a complete building (e.g. single-family house, multi-occupancy building, row house), i.e. the same commencement of construction applies to every building. The commencement of construction does not apply to a (complete) building complex.

Tax qualification should always be property-related. Property in this sense is taken to mean independent parts of buildings, such as the individual condominiums of a multi-occupancy building. If a property is also a building (i.e. single-family house), the two terms are identical. The VAT implications can be seen from the following example:

A developer builds a multi-occupancy building with 8 individual condominiums, of which 6 are sold prior to excavation works. It follows that the sale of these 6 condominiums is a taxable supply of real estate, and that of the remaining 2 a tax exempt without credit supply.

The published draft provides that if construction commences between 1 January 2010 and 30 June 2013, the above rules may be applied on a discretionary basis. The new practice applies only to structures on which construction is scheduled to commence after 1 July 2013.
Adoption of “minor” corporate tax reforms with new tax consolidation rules

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On 1 February 2013, after tough negotiations, the Federal Council approved the corporate tax reforms, and so the new tax consolidation rules (so-called “Organschaft”), the doubling of loss carry backs to EUR 1 million and the reformed tax law on travel costs can now come into force. The changes applicable to Organschaft are of particular practical significance. Tax consolidation structures are commonly used for the German inbound investment of Swiss entrepreneurs as part of their German tax planning if they have several established German companies. The current Federal government’s coalition agreement originally stated that the old Organschaft legislation would be replaced by a “modern group taxation system”. However, calculations showed that tax shortfalls would result, and so this major reform fell through and was replaced by minor reforms to the Organschaft rules. We would like to summarize below the key changes to the German Organschaft rules for the benefit of foreign investors.

Excursus: German Organschaft concept
A company with an unrestricted tax liability in Germany may apply fiscal profits consolidation for income tax purposes through profit transfer agreements with its German subsidiaries. Under this arrangement, all tax income for these companies (“controlled companies”) is combined and taxed at the level of the dominant company (“controlling company”). The tax charge can thus be reduced by netting profits and losses. Furthermore, the Organschaft group can also be seen as a business for the purposes of the “interest barrier”, i.e. German rules restricting the deduction of interest.

Need for action on existing profit transfer agreements
One of the conditions for the Organschaft is that there must be an effective profit transfer agreement in place. The latter must also provide for the controlling company to absorb losses as well as to transfer profits. The absorption of losses is governed by Article 302 of the Stock Corporation Act (AktG). In profit transfer agreements with a limited company, the obligation to absorb losses was previously structured to “correspond” with - i.e. to repeat the wording of - Article 302 AktG. As the “corresponding” structuring of the obligation to absorb losses was the cause of repeated disputes between taxpayers and the tax authorities, profit transfer agreements now just need to contain a dynamic reference to Article 302 AktG, partly to ensure that the current version of the provision is applicable. Existing agreements containing an incorrect obligation on the absorption of losses under the old rules must be amended by 31 December 2014 at the latest if the Organschaft does not end before 1 January 2015.

Limited partnerships or permanent establishments as controlling companies
Controlling companies may also be foreign corporations with German permanent establishments as well as limited partnerships. The conditions for Organschaft groups with permanent establishments and limited partnerships as parent companies were revised under the 2012 corporate tax reforms. The shares in the controlled company must now be allocated to a German permanent establishment of the corporation or partnership under German tax law and the applicable tax treaty, and any income from them subject to German taxation. Allocation is based on principles of function. The provision is designed to avoid situations where profits are assigned to foreign permanent establishments through the Organschaft and the German tax base is effectively shifted.

The structures affected by the new rules in particular are those where a limited partnership is used in Germany as the controlling company and the shareholders of this limited partnership are resident abroad. This change in the law means that the shares in the controlled company should be allocated to a German permanent establishment for recognition of the Organschaft between the limited partnership and the controlled company. Indicators of functional allocation can be the existence of a management agreement as well as close financial supply and service relationships. If there is no functional allocation to a German permanent establishment, then in principle, there can be no Organschaft between the limited partnerships and the controlled company. The subsidiary itself is then liable to tax on its profits and it would not be possible for these to be set against the limited partnership’s financing costs.

Prohibition on loss deductions for “double-dip structures”
Under the “minor” corporate tax reforms, the double domestic nexus (= head office and effective management in Germany) was removed for controlled companies, which can now be any corporation whose effective management is located domestically and its head office in an EU or EEA member state, and it follows that dual resident controlled companies are now possible. Legislators have now expanded the previous provisions restricting the dual consolidated loss rules to controlled companies. Nevertheless, this provision was also formally extended and negative income cannot now be deducted if it is also accounted for by another person. The provision of Article 14 para. 1 no. 5 of the Corporate Income Tax Act now includes controlling as well as controlled companies, and does not allow negative income to be deducted if the latter is accounted for in a foreign country under the tax arrangements of the controlling company, controlled company or another person. The application of this extension needs to be studied carefully, particularly if the controlling company is a limited partnership or permanent establishment of a Swiss company, and, for example, financing costs are claimed in both Switzerland and Germany as part of the scope of consolidation.
Selected cantonal outlooks and recaps

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Canton of Ticino

Vote on 3 March 2013 regarding changes in taxation of individuals and companies

On 3 March 2013, the electors of the Canton of Ticino will vote on the popular initiative “Sgravi fiscali: primo atto” launched by the right-wing party Lega dei Ticinesi.

The initiative proposes the following three changes to cantonal tax law, namely: i) reduction of the number of ranges for the determination of the applicable income tax rate and reduction of the latter, as well as the increase of the tax-free allowance for unmarried individuals (from CHF 12’000 to CHF 14’000) and married couples (from CHF 19’600 to CHF 22’500), leading to a general decrease of the income tax burden for individuals; ii) reduction of the cantonal corporate income tax rate from the current 9% to 6% over three years, leading to a general decrease of the cantonal and communal income tax burden for corporations; and iii) introduction of the tax credit for the equity tax in case corporate income tax is due.

Both the Cantonal Grand Council and the Parliament do not support the initiative, arguing that it would lead to excessive losses in tax revenues at cantonal and communal level, to a breach of the jurisdiction of the Federal Supreme Court regarding the tax treatment of married and unmarried couples and to minimal benefits for small and medium-sized businesses.

Lump sum taxation: Quo vadis?

In the government regarding the lump sum taxation and potential changes to the current regime is currently on hold. The outcome of the debate at the federal level - especially the fate of the popular initiative to abolish the lump sum taxation at the federal level - is likely to have a significant impact on the debate at the cantonal level. Nonetheless, it is expected that the Canton of Ticino will in any case amend its current lump sum taxation regime by making it more restrictive (minimum taxable amount for 2013 is currently set as CHF 300’000, in 2012 it was CHF 200’000).

Proposal of the Government to introduce a new real estate tax

The Cantonal Government has recently proposed to introduce a new tax that would apply on substantial increases in value of land deriving from changes to the land-use planning. Tax rates of 30% or 40% would apply on value increases depending on the nature of the change to the land-use planning (whereas increases in value up to CHF 50’000 would be exempt from the proposed new tax). New developments in this regard are expected to take place only after the outcome of the upcoming vote on 3 March 2013 on the reform of the federal law on land-use planning.

Western Switzerland Cantons

No news in the year 2012