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Rolf Wüthrich • Bastian Thurneysen

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Basel

burckhardt AG
Steinentorstrasse 23,
Postfach 258,
CH-4010 Basel

Zürich

burckhardt AG
Usteristrasse 12,
Postfach 1172,
CH-8021 Zürich

burckhardtlaw.com

Recapitalisations raise tax issues in Switzerland

Many businesses have required recapitalisation due to the COVID-19 pandemic. Bastian Thurneysen and Rolf Wüthrich of burckhardt explain why it is vital to consider how capital is provided to avoid any tax problems.

During the COVID-19 crisis, companies around the world were plunged into financial distress, due to regulatory action, supply chain disruption and other reasons. While governments quickly provided bridge loans to ensure short-term liquidity, this was often not enough, as many companies had to make long-term adjustments to their strategy in response to the changed circumstances.

These liquidity-intensive adjustments often required support from business partners, banks or shareholders in the form of capital, debt waivers and the like. However, the problem of recapitalisations has not only arisen since the COVID-19 crisis, but was also seen following the dotcom bubble in the late 1990s and the financial crisis in 2008.

Recapitalisation has always been an economic reality that can occur in the life of a company and it often arises in connection with M&A transactions. In this context, it refers to acquisitions of companies that are in the development phase and thus have an increased need for capital. From a tax point of view, it is important to pay close attention to the form in which capital is provided to the company to avoid unpleasant tax surprises. Special attention must be paid to the legal structure of recapitalisation measures, as there can be substantial differences from a tax point of view.

This article discusses various methods of recapitalisation, where the focus is on the recapitalisation of the balance sheet (restoration of equity capital). Debt capital measures such as (convertible) loans, guarantees and subordination are not discussed in detail as these measures provide liquidity but in principle do not restore the equity of a company.

General remarks on tax consequences

From a tax perspective, recapitalisation is defined as benefits provided to eliminate or reduce a genuine adverse balance. This means that capital

must be contributed to the company. No tax-relevant recapitalisation occurs if a loss carried forward is eliminated or reduced merely by accounting measures (e.g. revaluation of real estate and participations, release of provisions no longer required, capital reduction without simultaneous capital increase or subordination).

Depending on the structure, recapitalisations may trigger income tax, issuance stamp duty and in some cases withholding tax consequences. Furthermore, it must be considered to what extent tax loss carry forwards are lost as a result of the recapitalisation measures and whether capital contribution reserves can be created. Especially in the international context the advantage of capital contribution reserves is that they can be repaid to shareholders without triggering dividend withholding tax compared to the distribution of other reserves that may trigger withholding tax consequences.

Ordinary recapitalisations

Capital increase

Probably the most common way of increasing the capital of a company is to carry out a formal capital increase. From a tax point of view issuance stamp duty of 1% is due on the amount that is contributed to the company. However, there is a general allowance of Sfr 1 million capital that a company can claim in the course of the incorporation or a later capital increase.

Administratively, a formal capital increase is more complicated, as the articles of association and the commercial register must be adapted accordingly. In addition, a capital contribution confirmation from the bank is required in the case of cash contributions, and an audit confirmation from a licensed auditor is required in the case of contributions in kind.

The capital increase can be carried out either at par or above par with a corresponding premium. The premium can in turn be booked as a capital contribution reserve, whereby the following explanations regarding the offsetting of losses apply mutatis mutandis.

A formal capital increase requires the involvement of a notary, triggering notary fees which are often based on the amount of the capital to be subscribed. This requires the presence of at least one board member before the Swiss notary, which in practice often triggers major problems if the members of the board of directors of a Swiss company belonging to an international group are not Swiss residents.

As the formal capital increase is time consuming, costly and often too complicated from a practical point of view, other methods are often preferred for the implementation of recapitalisation measures.

Contribution in cash and debt waivers

The simplest way to provide liquidity to a company in need of recapitalisation is to make a cash contribution to its reserves. From a tax perspective special attention must be paid to whether the contribution is considered as a genuine or non-genuine recapitalisation contribution.

Cash contributions and debt waivers by third parties or debt waivers by shareholders that are granted under conditions equivalent to debt waivers by third parties (according to the arm's length principle) are so-called genuine recapitalisation income and thus subject to income tax. In this context, all loss write-offs, write-downs and provisions made to the debit of the genuine recapitalisation income are deemed to have been made for tax purposes.

Recapitalisation income can be offset against losses for an unlimited period compared to ordinary income that can only be offset with income within a period of seven years.

Contributions by shareholders

If the direct or indirect shareholders of corporations in need of recapitalisation make cash contributions, so-called non-genuine recapitalisation income is generated. The loss write-offs, write-downs and provisions charged to non-genuine recapitalisation income under commercial law are deemed not to have been made for tax purposes. With respect to debt waivers the situation must be assessed in more detail.

Bastian Thurneysen
Attorney, certified tax expert
burckhardt
T: +41 58 881 00 45
E: thurneysen@burckhardtlaw.com

Bastian Thurneysen is an attorney and certified tax expert at burckhardt. He specialises in national and international tax law with a special focus on Swiss-South African relationships.

Bastian advises corporate groups, SMEs and start-ups on all tax issues, in particular on M&A, financing, reorganisations and employee participation plans. He also advises on tax issues in the crypto area and assists private individuals in all tax matters.

Bastian was admitted to the bar in 2014 and holds a Master of Laws (LLM) in international tax law from the University of Cape Town as well as a diploma as a Swiss certified tax expert.

Rolf Wüthrich
Attorney, certified tax expert
burckhardt
T: +41 59 881 00 00
E: wuethrich@burckhardtlaw.com

Rolf Wüthrich is an attorney at burckhardt. He specialises in drafting and coordinating the implementation of group internal restructuring.

Rolf is an international tax lawyer focusing on national and international tax planning, inbound and outbound transactions, especially between the US and Switzerland, corporate restructuring and acquisitions as well as general corporate secretarial services.

According to the current practice of the Swiss Federal Tax Administration (SFTA), a debt waiver by a shareholder only qualifies as non-genuine recapitalisation income if the shareholder loan was treated as hidden equity (for tax purposes) before the recapitalisation or if the shareholder loan was granted due to the bad business situation and would not have been granted under the same conditions by third parties.

To be sure that the tax authorities qualify the contribution as a non-genuine recapitalisation contribution, it is advisable to obtain an advance tax ruling. Since the competent Swiss tax authorities normally only bindingly assess the taxable income but not the amount of the loss carry forward, it is often unclear in the year of a debt waiver to which amount a tax loss carry forward has been reduced by the debt waiver. Whether the debt waiver influences income tax or is neutral therefore becomes an issue in practice only years later when the company wants to offset the loss carry forwards against ordinary income.

In addition, it must be ensured that capital contribution reserves (that can be repaid without withholding tax if the contribution is paid by the direct shareholder, though contributions by grandparent-, sister-, or other group companies never qualify as capital contribution reserves) are only accepted if a debt waiver is booked directly in the balance sheet without affecting income and the commercial law losses are not offset with the contribution.

Special attention in this context must be paid to issuance stamp duty. In general, any contribution by the direct shareholder is subject to issuance stamp duty of 1% (payable by the receiving company). Thus, the registration of a capital contribution reserve will trigger a 1% stamp duty but will allow the company to repay future profits free of Swiss withholding tax of 35% to its shareholders as capital repayment.

Under the current practice of the SFTA, an issuance stamp duty recapitalisation allowance of up to Sfr10 million can only be claimed if the losses are eliminated in accordance with commercial law with the cash contribution or the debt waiver. In this case no capital contribution reserve can be created.

The Swiss Federal Administrative Court recently declared this practice inadmissible. However, it is not yet clear whether the ruling will be appealed to the Swiss Federal Supreme Court and whether or not it will be upheld. If the ruling becomes final, it would be possible to benefit from the recapitalisation allowance of up to Sfr10 million without paying the issuance stamp duty and to register at the same time a capital contribution reserves.

For an amount exceeding the Sfr10 million allowance, a request for relief can be submitted to the SFTA. Regarding the relief, it was also practice until now that the losses had to be written off in accordance with commercial law, but this practice was also declared by the Federal Administrative Court to be contrary to federal law. As it is not possible to appeal the ruling to the Federal Supreme Court regarding the relief, this part of the ruling is final.

Alternatives to debt waivers

To avoid the above situation, if the debt waiver is considered as taxable income (reducing the tax loss carry forward) or a tax neutral contribution, there are other ways to recapitalise a company.

First, the direct or indirect shareholder can contribute a receivable against the subsidiary as a contribution in kind to the subsidiary to be recapitalised. This is considered an income tax-neutral contribution to the reserves of the company being recapitalised. The reason for the elimination of the receivable is due not to the tax effective waiver of the receivable, but to the profit tax-neutral 'merger' of debtor and creditor following the contribution.

Alternatively, the shareholder, as creditor of an existing receivable, can decide to make a contribution to the subsidiary in the same amount and thus establish a new receivable by means of a contribution agreement. In a second step, the subsidiary (or the parent company) declares the offsetting of its debt against its receivable from the promise of contribution.

If one of these measures is taken by the direct shareholder, the contribution is subject to issuance stamp duty of 1%; however, these exemptions of recapitalisations (Sfr10 million allowance and relief for companies in need) generally apply.

In addition to the tax consequences for a company being recapitalised, attention must also be paid to the tax consequences for the company making the recapitalisation.

Recapitalisation by parent companies

If the recapitalisation payment originates from the parent company, the question arises whether it is a genuine or non-genuine recapitalisation payment.

Whereas genuine recapitalisation payments can be written off for income tax purposes, non-genuine recapitalisation payments are investments that have to be capitalised. Accordingly, the initial costs of the recapitalised company increase, which has the consequence that in the case of a later sale, a possible capital gain – which is subject to the participation relief – is lower.

Recapitalisation by sister companies

Debt waivers and other contributions from Swiss sister companies are treated differently from a tax perspective if the recapitalisation is not at arm's length (which is usually the case).

For corporate income tax purposes, debt waivers and other contributions are commercially not justified and are therefore added up to the taxable income. Special attention must also be paid to withholding tax – especially in an international context – as the so-called triangle theory is applied.

Since the SFTA considers it the duty of the parent company to recapitalise a subsidiary, recapitalisation measures paid by sister companies are considered to be deemed dividends to the parent company with a subsequent contribution from the parent to the company that needs recapitalisation.

As the sister company carrying the recapitalisation costs is not a qualifying shareholder in the sister company in need of the recapitalisation, only a refund of the Swiss withholding tax for non-qualifying corporate shareholders and individuals will be granted under the applicable double tax agreement (DTA).

The assumption under the triangle theory that the recapitalisation must be carried out by the direct shareholder can lead to unpleasant tax consequences, particularly in cases where a recapitalisation payment is made by a subsidiary to the second-tier subsidiary of the common parent company (so-called bent triangle).

Regarding withholding tax, a payment between sister companies (subsidiary to shareholder of the second-tier subsidiary) is assumed, which leads to the fact that according to most DTAs the portfolio rate of 15% is applied (refund of 20%). However, if there is no DTA in place with the state of residence of the shareholder of the second-tier subsidiary, the withholding tax of 35% cannot be refunded at all.

Merger

Restoration of equity can often be achieved through an intragroup merger with either a parent or sister company. From a tax perspective, a merger is in general tax neutral if the transaction takes place at book values and the acquiring company remains in Switzerland. However, especially regarding withholding and income tax purposes, there are some issues that need to be clarified in advance.

If merger losses arise during an upstream merger (the difference between the asset surplus of the acquired company and the higher book value of the acquired participation), only so-called genuine merger losses can be claimed for tax purposes. Non-genuine merger losses, in which the hidden reserves and the goodwill compensate for the book losses, cannot be claimed for tax purposes.

Regarding loss carry-forwards, it should be noted that the absorbing company can in principle take over the losses carried forward of the absorbed company and can offset them with current or future taxable profits. However, the offsetting of losses is denied if the absorbed company's assets are mainly current assets, the business is discontinued shortly after the merger or has already ceased to operate prior to the merger.

If reserves are lost in the merger on the level of the absorbing Swiss parent company (i.e. if the book value of the Swiss or foreign subsidiary in the balance sheet of the parent is higher than the nominal share capital and the capital contribution reserves of the absorbed subsidiary), the difference between such book value in the books of the parent and the total of nominal capital and capital contribution reserves of the subsidiary is subject to withholding tax.

However, if a foreign parent company absorbs a Swiss subsidiary, the Swiss subsidiary is liquidated from a withholding and corporate income tax perspective, i.e. all hidden reserves (valuation at fair market value) are subject to corporate income tax and both the hidden reserves and the ordinary reserves are subject to withholding tax. A possible refund of the withholding tax must be examined in accordance with the applicable DTA.

Need for advance clarification

As explained above, there is a wide range of possibilities for restoring the equity, but each has different tax consequences. In order to avoid unexpected tax consequences, recapitalisation measures, especially in an international context, should therefore be carefully clarified in advance.

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burckhardt Ltd provides its clients and their businesses with comprehensive advice on national and international tax planning issues and structuring. It offers corporate, general, secretarial and notary services, and regularly supports clients with its professional expertise and broad international experience on restructurings, mergers and joint ventures. The firm has experience in advising on inbound and outbound investments, as well as on financing, and in all matters related to employment, trade and transport law.