Taxation of Private Investment Income under the Second Business Tax Reform

The Second Business Tax Reform Act was approved on 24 February 2008 and generally will come into force as from 1 January 2009. This Reform is meant to increase the efficiency and strengthen the competitiveness of the Swiss tax system, with a special focus on small and medium-sized entities. This article provides an overview of how the Second Reform will impact the taxation of private investments in Switzerland.

1. Background

The Second Business Tax Reform Act (Reform II) was approved on 24 February 2008 in a public referendum, and will come into force as from 1 January 2009, subject to certain stipulations which only will come into force as from 1 January 2011. Reform II is meant to increase the efficiency and strengthen the competitiveness of the Swiss tax system, with a special focus on small and medium-sized entities. This article will provide an overview of how Reform II will impact the taxation of private investments in Switzerland.

Reform II introduces certain changes, at the federal and cantonal tax levels, to the classic system of economic double taxation of corporate profit, which consists of profit taxation at the corporate level and subsequent taxation of distributed profits as income in the hands of individual shareholders. Some of these changes are compulsory for the cantons, while some grant the cantons flexibility and provide guidance in their efforts to achieve competitive tax regimes.

Overall and in the short term, Reform II is expected to cut tax revenues by approximately CHF 500 million. In the long run, however, the government is expecting positive effects on economic growth, which will eventually outweigh the short-term losses in tax revenue.

This article will focus on the tax effects of Reform II for individual investors in corporations. An analysis of most of the changes affecting self-employed persons is beyond the scope of this article.

2. Taxation of Dividends

2.1. The system to date

Currently, distributed profits of corporate entities are taxed twice: first, the profits are taxed at the level of the corporate entity through corporate income taxes, and second, upon distribution of the corporate profits, the resident individual shareholder incurs personal income tax liability on the dividend received.

The individual shareholder cannot claim any tax credit for the income tax paid at the corporate level, nor will the corporate entity receive any credit, deduction, discount or other benefit upon distribution of its profits. Thus, purely from a tax perspective, the distribution of profits to individual shareholders is less advantageous than the payment of interest or employment remuneration. The latter items are, in principle, deductible from income at the corporate level, while they are taxed in the same manner in the hands of the resident individual shareholder as a dividend. This fiscal situation has created a trend for closely held Swiss corporate entities either to distribute economic profits to their individual shareholders in the form of interest or salary, or to retain the profits at the corporate level.

In addition to income tax, any profit distribution by a resident corporate entity is subject to dividend withholding tax at the level of the distributing corporation. Dividend withholding tax is imposed at 35% on the gross amount of the distribution. Resident taxpayers who beneficially own the dividend and duly declare it for tax purposes benefit from a tax credit of 20%.

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their own income tax purposes are generally entitled to full relief of the dividend withholding tax, either through refund of the tax or through credit against the personal income taxes at the federal and cantonal/communal levels. Thus, the dividend withholding tax will under normal circumstances not result in any additional tax burden for resident shareholders. However, for non-resident shareholders the dividend withholding tax generally constitutes a final burden, unless the non-resident is eligible for benefits (i.e. a partial or full relief from or credit of Swiss dividend withholding tax) under an applicable income tax treaty between Switzerland and the shareholder’s state of residence.

Swiss laws regarding income taxes and dividend withholding tax provide a broad definition of “dividend” and “distribution.” Essentially, for purposes of income taxation of private individuals and dividend withholding tax, any payment or benefit of monetary value made to a shareholder (or to any other person who is related or close to the shareholder) from the corporate entity, not compensated otherwise, is considered a taxable dividend, unless the benefit constitutes a repayment of the nominal capital (so-called nominal value principle). This excludes any monetary or other benefits, for which the corporate entity receives an arm’s length consideration in money or in kind.

On the other hand, as a very important exception, federal and cantonal income tax laws provide, in principle, that capital gains arising in the hands of resident individuals upon the sale or exchange of movable assets (such as equity and debt securities) held as private, non-business property (private capital gains) are not subject to personal income tax. As a consequence, private shareholders of closely held corporate entities have an incentive to cause their company to retain profits rather than distributing them, as they may eventually realize the value of undistributed corporate profits through a sale of the shares on a tax-free basis (subject to certain income tax rules and practices, whereby in some instances a portion of the sale proceeds or the capital gain may be characterized as a taxable business gain or as a dividend from indirect partial liquidation). This may be one explanation why many privately owned Swiss companies are holding rather substantial liquid reserves that they do not really need for their business operations.

Corporate investors (and individual investors holding shares as business assets) are subject to a different tax regime. The nominal value principle is of almost no relevance at all for their income tax position. Income and gains of such categories of investors are essentially determined on the basis of their commercial (statutory) books and accounts (book value principle). This is the case, in particular, with regard to income and gains derived from equity and debt securities. Any dividend received by such an investor will constitute an element of gross income. On the other hand, the dividend may give rise to an adjustment of the book value of the underlying shares in the investor’s accounts (depreciation). The depreciation of the investment reduces the taxable net profit and may effectively offset the dividend.

The differing dividend and gains tax regimes applicable to private individuals and to businesses, respectively, have traditionally favoured transactions with an element of tax arbitrage, whereby resident “private investors” would sell their cash-rich corporation to a corporate investor, thereby seeking to realize a tax-free private capital gain. The buyer would have a fair chance of effectively realizing the underlying value without incurring any income taxes. He could largely eliminate the gross income effect of any substantial distribution received from the acquired participation by deprecating the shares at the same time. A corporate investor would also have the option, under certain conditions, to claim a “participation exemption” in respect of the dividend received.

The specific rules on indirect partial liquidation (see above) and on transformation (Transformation) are intended to limit these tax arbitrage opportunities. Transformation is relevant in the event of a sale of shares by private individuals to corporate entities in which the selling individuals hold a controlling interest. Indirect partial liquidation and transformation were originally intended to form an integral part of Reform II. However, they were eventually fast-tracked and have already been legally implemented through separate legislation.

2.2. New dividend tax relief

Reform II is primarily aimed at reducing the tax incentives for retaining corporate earnings at exaggerated levels by softening the effects of the classic system of economic double taxation of corporate net profits. By doing so, Reform II also attempts to reduce the number of practical cases involving tax issues of indirect partial liquidation or of transformation. Essentially, Reform II tackles the issue by reducing the taxable income base of individual shareholders with regard to dividends received from qualifying holdings.

From 1 January 2009, the federal tax system will introduce a partial taxation of dividends received from shareholdings of at least 10% in the nominal capital of the cor-

13. Art. 22 and 24 VSStG.
15. i.e. resident individual investors who hold their corporate shares as part of their private, non-business assets.
16. Switzerland generally applies the OECD transfer pricing guidelines.
17. See Reich, in Zweifel and Athanas, Kommentar zum schweizerischen Steuerrecht, Bundesgesetz über die direkte Bundessteuer (DBG), Art. 1 – 82, Art. 20 N 31 ff.
18. Art. 16, Para. 3 DBG, Art. 7, Para. 4, lit. b StStHG.
20. Art. 57 DBG; Art. 24, Para. 1 StStHG.
21. Art. 57 DBG; Art. 24, Para. 1 StStHG.
22. Art. 69 f DBG; Para. 1 and 1bis StStHG.
23. Art. 20a, Para. 1, lit. b DBG.
porate entity. Federal income taxes on individuals are imposed at progressive tax rates, up to a maximum rate of 11.5%. If the 10% or greater capital stake in a Swiss or foreign corporation or cooperative is held as private, non-business property by a resident individual, only 60% of the dividend will be taxed, and 40% will be tax exempt. If the 10% or greater stake belongs to the business property of a resident individual, or to a fixed place of business (permanent establishment) in Switzerland of a non-resident individual, 50% of the dividend will be taxable, and the remaining 50% (and capital gains, subject to a one-year holding period) will be tax exempt. Capital gains on privately held shares continue to be tax exempt.

The cantons may also amend their cantonal tax laws to provide for certain tax relief on dividends from substantial shareholdings owned by individuals. The tax burden of cantonal/communal income taxes varies substantially among the different cantons, and even among the communes of the same canton. Marginal cantonal/communal income tax rates may reach slightly over 40% in certain cantons.

The cantons enjoy certain flexibility as to the technical implementation of the dividend tax relief. While some cantons have introduced a similar dividend relief system as the Federal government, most other cantons (e.g. Zurich) take a slightly different approach, as they do not provide for a partial tax exemption, but rather for some relief through a reduced tax rate. In the canton of Zurich, individuals receiving dividends from a shareholding of at least 10% of the capital of a corporation or cooperative benefit from a reduction by 50% of the tax rate on that dividend, compared to the tax rate that would otherwise apply to the individual’s entire taxable net income. Under Zurich cantonal law, the corporation or cooperative must have its seat in Switzerland in order for the dividend tax rate reduction to apply. The new Zurich cantonal dividend tax regime has been applicable since 1 January 2008.

The tax rate cut system applied by the canton of Zurich has a greater effect when the taxpayer overall is in a high tax bracket. On the other hand, the federal partial tax exemption system may reduce the overall applicable tax rate, in addition to exempting a fraction of the dividend from tax, especially when the taxpayer is not subject to the highest marginal federal tax rate.

The limitation of the dividend tax relief to significant shareholdings has met some criticism, because portfolio investors holding smaller equity stakes in a company are excluded from the dividend tax relief. The limitation was mainly implemented to limit the anticipated reductions in tax revenue. Also, foreign investors in Swiss companies will not benefit from this reform measure, unless they hold a qualifying equity interest through a Swiss business establishment.

Reform II was meant to strengthen small to medium-sized companies and their shareholders. However, shareholders are not required to actively work in the corporation’s business to benefit from the dividend tax relief.

2.3. Dividend versus employment income

Under the classic system of economic double taxation, active owners of closely held corporations would tend to maximize the amounts they can receive as employment remuneration from their company, as employment remuneration paid to shareholders is, in principle, a tax-deductible business expense at the corporate level. The tax authorities would typically scrutinize excessive salaries from the perspective of a constructive dividend. Dividends are not tax deductible at the corporate level.

Dividend tax relief under Reform II might lead some active shareholders to change their behaviour, i.e. to reduce their own employment remuneration in favour of higher dividends. That may be the case in particular, where cantonal laws relieve a greater portion of qualifying dividends from personal income tax, such that the saving on personal taxes and social security charges exceeds the incremental corporate tax cost of a higher taxable net profit at the corporate level.

Unlike dividends, employment remuneration paid to shareholders is subject to several social security contributions, most of which are typically borne by the employing company to the extent of 50%, and by the employee for the balance. The federal social security system, known as AHV/IV/EO, is referred to as the first pillar. It provides for old age and survivors’ insurance, as well as disability insurance. The combined contribution on the relevant employment remuneration amounts to 10.1%. For the first pillar, contributions on employment remuneration are not capped.

Furthermore, federal law provides for an occupational pension fund, which constitutes the second pillar. Swiss pension plans are organized through legally separate, tax-exempt special purpose vehicles, typically foundations. Within a certain range of the employee’s remuneration, participation in the second pillar is mandatory. However, most employers provide second-pillar.

25. Art. 214 DBG.
26. Art. 20a, Para. 1, lit. a DBG.
27. Art. 20a, Para. 1, lit. b DBG.
28. Art. 16, Para. 3 DBG.
29. Art. 5, Para. 1 SG; see Giger and Schmid, note 3, at 111.
30. See e.g. Art. 188 Zurich Cantonal Tax Act (Steuergesetz Kanton Zürich StG-ZH).
31. Art. 35, Para. 4 StG-ZH.
32. Id.
33. OS 63, 7.
34. See Giger and Schmid, note 4, at 111.
36. Art. 48, Para. 2 Occupational Pension Fund Act (Bundesgesetz über die berufliche Vorsorge, BVG).
37. Art. 8 BVG. Currently, the compulsory portion consists of an insurance on annual employee remuneration between CHF 23,205 and CHF 79,560. Annual remunerations up to CHF 23,205 is covered only under the first pillar. However, any employee with an annual gross salary of more than CHF 19,890 must be insured under the second pillar for a minimum amount of CHF 3,315. See Art. 3a Ordinance to BVG.
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coverage beyond the required minimum. The maximum annual remuneration that may be insured under the second pillar currently amounts to CHF 795,600. Employers must bear at least 50% of the contributions to the company pension plan.

As a rule, pension plans may not be individualized, but should rather be collective for an entire class of employees at least. The employer's portion of the contributions paid to the pension plan is tax deductible as a business expense. Employees may deduct their portion of the pension plan contribution from their personal income.

On the other hand, any benefits received by employees from pension plans are fully taxable. If the benefits are paid as a capital payment, they will be taxed separately from other income and at a reduced tax rate (on the federal level, one fifth of the ordinary tax rate that would apply to the capital payment alone). Therefore, pension plan contributions have a tax deferral effect for the employee, and may also reduce the overall tax burden that will arise on the payment of the benefits.

Under the classic system of economic double taxation, "excessive" pension plan contributions for employees who are also shareholders of the employer have been scrutinized by the tax authorities as constructive dividends. With the new dividend relief, the pressure on maximized pension plan contributions for shareholder employees might be slightly reduced, because funds in the pension plan are basically blocked until retirement age, while dividends received are freely disposable.

There have been some attempts, mainly by social security offices, to define minimum levels of "appropriate" salaries for substantial shareholders who are employed in the business of their company. The Federal Office for Social Security has suggested that dividends paid to shareholders who hold a "qualified" (at least 10%) shareholding in the Swiss company by which they are also employed, should be recharacterized as employment remuneration, subject to social security contributions, to the extent that the dividend exceeds a 15% return on the paid-up share capital, but only if the employment remuneration is below market standards.

However, the Social Security Law Chamber of the Swiss Federal Supreme Court recently rejected such an approach. The Supreme Court conceded in principle that payments made by a corporation to a shareholder who is also employed by the corporation should be reviewed from the perspective of an appropriate investment return, as well as from the perspective of an appropriate employment remuneration. The Court also noted that the payment of high dividends and low employment remuneration to a shareholder-employee provides not only tax advantages. Certainly, a high dividend at the expense of the employment remuneration will provide savings on social security contributions, while a dividend eventually benefits from the reduced income taxation under Reform II. However, that advantage is somewhat offset by the higher corporate tax burden resulting from the increased corporate net profit. The Court held that corporations have a considerable degree of discretion in deciding whether to pay higher employment remuneration or higher dividends to their shareholder-employees. It suggested that the assessment done by the tax authorities generally should be followed by the social security authorities. In other words, a recharacterization of a dividend into employment remuneration, for social contribution purposes, should be made only when there is an obvious disproportion between the employment remuneration and the dividend.

2.4. Dividend versus capital gain

The new dividend relief reduces the disincentive for resident private individuals to receive dividends from their corporate investment. Under the classic system of economic double taxation, private shareholders of closely held corporations would generally tend to avoid receiving dividends, on which they would suffer full personal income tax including potentially an increase in the income tax rate (progression). Instead, they would seek to eventually realize the increased value of their investment through a sale of the shares, thereby realizing a tax-free private capital gain. The new dividend relief should facilitate the regular receipt of profit distributions. Therefore, the pressure under the indirect partial liquidation rules should also be gradually reduced.

2.5. Dividend versus interest

Thus far, the classic system of economic double taxation has made it rather attractive for private shareholders to fund their corporate business entities with a large portion of shareholder loans in addition to equity capital. The shareholders would be equally taxed on the dividends and on the loan interest received from the company. However, the interest income received on the loan portion would principally be deductible as a business expense at the corporate level, and the loan interest would generally not suffer any dividend withholding tax, while the capital return in form of dividends is not deductible from net income at the corporate level and is subject to dividend withholding tax.

The Swiss tax authorities have developed practice guidelines to prevent shareholders and related parties from capitalizing their companies with excessive amounts of debt rather than equity (so-called thin capitalization
The new dividend relief might induce individual shareholders to reduce the interest charges made to their companies on the shareholder loans in favour of increased corporate profits and profit distributions, especially when the arbitrage between the corporate tax and the personal income tax favours the receipt of dividends. Thus far, Swiss tax practice has not intervened when individual shareholders granted their companies loans at favourable conditions such as a low or zero interest coupon. Generally, no interest was imputed for tax purposes, neither at the corporate nor at the individual shareholder level. Interest imputation for tax purposes would occur only when a loan goes in the opposite direction, i.e. from the corporation to its shareholder. It remains to be seen whether Swiss tax authorities will modify their practice with regard to low- or no-interest shareholder loan funding as a consequence of the new dividend relief rules.

3. Repayment of Capital

Reform II will introduce a tax relief in respect of repayments of capital contributions made by shareholders to a company. At present, the income tax treatment of private individuals and the dividend withholding tax regime are driven by the nominal value principle. Any amounts which the shareholder receives from the company in excess of the nominal value of the shares are treated as a taxable distribution for personal income tax and dividend withholding tax purposes. This may lead to – economically unjustified – taxation of contributed surplus, share premium and other contributions made by the actual or previous shareholders of the company.

Reform II will introduce an equal treatment, for personal income tax and dividend withholding tax purposes, of the repayment of share premium, surplus and other capital contributions made by shareholders to a company after 31 December 1996 with the repayment of nominal share capital. All these forms of capital repayment will become tax neutral. This reform measure will become effective as from 1 January 2011.

The dividend withholding tax element of Reform II will in particular benefit non-resident investors as well, who up to now could not be repaid for their premium and other informal capital contributions without suffering dividend withholding tax (subject to partial or full relief under any applicable Swiss income tax treaty).

4. Structuring Aspects for Investments of Resident Individuals

Partial taxation of dividends received by individuals is limited to investments representing a certain percentage of the capital of the underlying Swiss company. On the federal level, Reform II does not provide for any alternative referral to the value of the shareholdings. However, in some cantons an alternative referral based on the value of the shareholdings is available.

The limitation of dividend tax relief to shareholdings of at least 10% (cantons may define different thresholds) and to shareholdings in Swiss corporations (as provided under many cantonal tax laws) might induce a number of resident individuals to interpose a Swiss corporation to hold those investments that are not eligible for individual dividend tax relief. The receiving corporation could then receive the dividends substantially tax free, and subsequently make a distribution to the individual shareholders, who could claim partial tax relief for the dividend received from their “qualified” investment.

Dividend relief at the corporate tax level (i.e. the participation exemption) requires a shareholding of at least 20% in the capital in a Swiss or foreign company, or a fair market value of the shares of at least CHF 2 million (as from 1 January 2011, these thresholds will be halved).

The disadvantage of such a strategy (of interposing a Swiss corporation) consists in the fact that the underlying investment may no longer be sold at a gain without attracting some tax. At the federal level, the gain realized by the corporation on a shareholding of less than 20% (or less than 10% from 1 January 2011) is not eligible for the participation exemption. Thus, the corporate profit will attract an effective tax of at least 7.83% federal tax. Cantonal/communal tax may not be applicable if the selling company holds a “holding company” tax privilege.