# Legal Compass

## Tax Law

June 2022

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# Circular Letter 5a regarding restructurings - an overview

**Circular Letter No. 5 of 2004 (CL 5 - Restructuring) of the Swiss Federal Tax Administration (FTA) was revised after 18 years and replaced by the new Circular Letter No. 5a (CL 5a), which came into force on 1 February 2022. It regulates at the federal level the tax consequences in the case of restructurings of partnerships and legal entities.**

**In addition to various editorial changes, the relevant Federal Court rulings and FTA practice adjustments issued since 2004 have been incorporated. Furthermore, CL 5a reflects the legal changes of the Tax Reform II (2009) as well as the Federal Law on Tax Reform and AHV Financing, which came into force in January 2020. This Legal Compass provides an overview of the most important changes and shows what concrete practical effects they entail.**

## 1. Scope of application of CL 5a

CL 5a specifies the tax consequences of restructuring at the federal level. Although CL 5a is not binding for cantonal taxes, most cantonal tax administrations strongly rely on it as a guidance.

## 2. The most important changes at a glance

While CL 5 only mentioned in passing that "restructurings" also include those not covered by the Merger Act (Merger Act), CL 5a now makes this unequivocally clear. In addition, the distinction between old and new shareholdings is henceforth dispensed with.

Selected changes are discussed in more detail below. These include the partially tax-neutral reorganizations (2.1), the merger (2.2), the split (2.3) and the spin-off of shareholdings (2.4).

### 2.1 Partially tax-neutral restructuring

#### 2.1.1 Transfer of hidden reserves in the context of a restructuring

With regard to income tax, the new rule is that in the case of a restructuring that is not completely tax-neutral, the difference between the income tax values before and after the restructuring is taxed. Thus, in this case, the undisclosed hidden reserves remain tax-free.

The facts qualifying for partial taxation in the case of participations in the business assets of natural persons are reserved. Such income and gains from the sale of equity securities are taxable at a rate of 70% after deduction of the attributable expenses if the equity securities account for at least 10% of the share capital of a corporation. The partial taxation of the capital gain requires a holding period of at least one year for the equity securities sold.

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The same applies with regard to profit tax if, in the course of a restructuring, hidden reserves on individual assets are not transferred in a completely tax-neutral manner by increasing the profit tax values to a value below the market value. Again, the difference between the profit tax values before and after the restructuring is in principle included with the transferring company's profit tax, whereby the undisclosed transferred hidden reserves are not taxed.

The two changes are welcomed by professionals, as previously partially tax-neutral restructurings were tacitly accepted by the FTA, while there were differing views on this in the cantons. At least at the federal level, clear rules have now been established in this regard, which will probably also be adopted by most tax offices for the purpose of cantonal and municipal taxes.

### 2.1.2 Restructuring of partnerships and transfer of a business/partial business to a legal entity

The most common case here concerns the conversion of a partnership or a sole proprietorship into a corporation (Ltd., LLC), whereby this is done either by means of a contribution in kind to the new corporation to be formed or by means of a transfer of assets in accordance with the Merger Act.

In principle, the (partial) transfer of a business to a legal entity whose participation rights are held as private assets can be carried out in a tax-neutral manner, provided that (i) the tax liability in Switzerland continues to exist, (ii) the values previously relevant for income tax are taken over, (iii) the business assets transferred are a business or part of business, and (iv) the participation rights in the acquiring company are not sold during the 5 years following the transfer (lock-up period).

CL 5a specifies the following with regard to partial taxation: The transfer of a (partial) business to a legal entity whose participation rights are in the business assets of a transferring natural person or partnership leads, in principle, to a realisation to the extent of 30% of the transferred, hidden reserves in the case of a transfer to a qualifying participation (partial taxation) at federal level. However, such a transaction constitutes a restructuring in which all transferred hidden reserves are not taxed, provided that the aforementioned blocking period (iv) is observed.

With regard to this blocking period, the sale of a single participation right already constitutes a violation of such period and leads to a proportionate subsequent taxation of the transferred reserves. However, whether there was already an intention to sell at the time of conversion or whether this only occurred at a later point in time is not relevant for tax purposes.

## 2.2 Merger

In principle, the acquiring company can claim previous year's losses of the transferring company that have not yet been taken into account when calculating the taxable net profit. With reference to various Federal Court rulings issued in the meantime, CL 5a now states that an assumption of the previous year's losses is excluded if, from a dynamic point of view, there are no business reasons for a merger or there is tax avoidance. This is particularly the case if the transferring company has either already been economically liquidated or brought into liquid form (shell company).

## 2.3 Split

Generally speaking, a split occurs when a company transfers parts of its assets to another company. The Merger Act distinguishes between a (i) split-up, i.e. all assets are transferred and the transferring company is deleted, or a (ii) split-off, i.e. only parts of the assets have been transferred to another company. From a tax point of view, this distinction is not important, but only the economic effect of the reorganisation.

### 2.3.1 Mandatory absorption of prior-year losses

Previously, it was possible to transfer the previous year's losses attributable to a business or part of a business to the acquiring company in the event of a split. Now, this is a mandatory requirement. However, an exception exists in the case of tax avoidance, for example, if the (partial) business is discontinued immediately after the split. In such a case, the transfer of prior year losses is excluded.

### 2.3.2 Holding split

With regard to holding companies, the mere holding and management of securities that serve only to invest own assets never constitute an operational activity, even if the assets are large. In the case of a holding company, the operating requirement may exist at the holding company level ("holding operation") or at the level of the active companies in which the holding company holds an interest ("operative business"). According to a Federal Court decision issued in 2019 on this topic, an operating business exists if the shareholding amounts to more than 50% of the voting rights in an active company. According to the transparency principle, even a single participation like this fulfills the operating requirement of an operative business.

### 2.3.3 Allocation of self-created added value

With regard to self-created added value, CL 5a specifies that the profit tax value of the self-created added value at the time of the split must be allocated to the remaining and transferred (partial) businesses. For the calculation of the added values of the individual (partial) businesses, the valuation method chosen at the beginning of the tax liability is to be applied.

This rule also applies *mutatis mutandis* in the case of (i) a spin-off of (parts of) operations and items of operating fixed assets to a subsidiary and (ii) in the case of the transfer of assets between domestic group companies.

## 2.4 Spin-off

A spin-off is when a company transfers assets to a company in which it has a new interest or in which it already has an interest.

### 2.4.1 Spin-off of (partial) operations and fixed assets

In this respect, everything remains the same, which also applies with regard to the definition of a subsidiary. Such a subsidiary is a company in which the transferring company holds at least 20%. Furthermore, the spin-off can also be made to a Swiss permanent establishment of a foreign subsidiary. In this case, however, it must be ensured that the transferred hidden reserves continue to be allocated to Switzerland for taxation without restriction.

### 2.4.2 Spin-off of participations

A spin-off of participations is deemed to be the transfer of at least 10% share in a corporation to a domestic or foreign subsidiary. A company in which the transferring company holds at least 10% of (i) the capital or (ii) the profit and reserves is now defined as a subsidiary. CL 5a makes it clear that a spin-off of participations is merely an exchange of participations and thus cannot result in a realization for tax purposes. Accordingly, in principle, there is no restructuring situation.

With regard to the transfer of hidden reserves in participations to a subsidiary, the new rule is that taxwise a realization of the hidden reserves can only take place if:

- (new) the shares transferred represent less than 10% (previously 20%) and the participation in the acquiring company represents at least 10% (previously 20%) of the capital or there is an entitlement of at least 10% to the profits and reserves of the other company; or
- (as before) if the transferred shares are booked by the acquiring company above the previous income tax value.

In connection with this, CL 5a states that if the transferred participations in a foreign subsidiary are recognized in the balance sheet above the previous profit tax value, the indirect revaluation in the parent company will only be recognized for tax purposes upon a possible retransfer of the participations to the domestic market.

The reduction of the shareholding threshold from 20% to 10% follows a long-standing practice of the tax authorities, which is very welcome.

### 3. Conclusion and outlook

From the point of view of the companies concerned, the majority of the innovations in CL 5a are quite pleasing and were long overdue for the last 18 years. The adjustments bring more legal certainty and planning security for the companies and enterprises concerned.

Finally, it should be emphasized that obtaining an advanced tax ruling is still indispensable, as this is the only way to obtain a binding opinion from the tax authorities of a planned restructuring in advance. We will be happy to assist you with any questions you may have on the tax implications of restructurings.

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