Virtual Case Experience Corporate Tax

Model Work Task 2

Step 1 – First assessment I

This transaction could potentially trigger an indirect partial liquidation pursuant to Art. 20a para. 1 lit. a federal act on the direct federal tax (DFTA) and § 20a para. 1 lit. a Zurich cantonal tax act (TA ZH).
A fundamental principle in Swiss tax law is that capital gains on moveable property held as private assets are exempt from taxation. On the other hand, a distribution of the retained earnings of QuickShip AG to its shareholder Mr. Seagull would be subject to income tax at the level of the shareholder (repayment of nominal capital and qualifying legal reserves are exempt). Although in case of qualifying investments of more than 10% the dividend income is partially exempt from taxation at federal level (partial taxation of 70%) as well as at cantonal and communal level (partial taxation of between 50% and 70% depending on the canton), there would be income tax consequences.

In case the investment is transferred by an individual to a corporation (or to an individual holding the shares as business property or a partnership) it would be subject to the book value principle going forward. Accordingly, the new shareholder could distribute the retained earnings without tax consequences (e.g. by means of a so-called substance dividend, i.e. a dividend distribution with consequent impairment of the investment), which would not result in a taxable income at the level of the new shareholder due to the book value principle. Accordingly, the purchase price could be settled by the FlyByU Holding AG with the retained earnings distributed out of the newly acquired QuickShip AG after the acquisition.

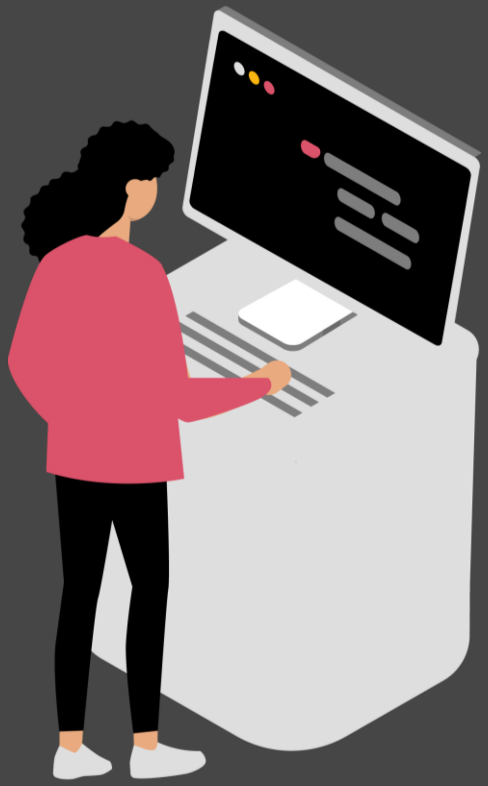
This would result in a more favourable income tax situation for Mr. Seagull compared to a distribution of the reserves prior to the transaction (i.e. Mr. Seagull indirectly receives the value of the retained earnings, which would have been subject to income tax in case of a distribution, as part of the tax exempt capital gain on private property). The Swiss indirect partial liquidation rules emerged from an anti-abuse practice applied by the tax authorities, which was formalised in the law. In case of an indirect partial liquidation (a part of) the capital gain resulting upon sale of the shares in QuickShip AG would be requalified into dividend income subject to partial taxation at the level of Mr. Seagull. There are no immediate tax consequences triggered by an indirect partial liquidation at the level of the acquiring company.

Step 1 – First assessment II

An indirect partial liquidation is triggered provided that at least 20% of the shares in a corporation are transferred from the private assets of an individual to a corporation, the business assets of an individual or a partnership. Further, it is required that within five years after the transaction non-operational substance is distributed by the transferred company. Such non-operational substance had to exist at the time of the transfer and be distributable based on the Swiss Code of Commerce. Pursuant to the law the seller has to participate in the distribution of the reserves of the transferred entity for the rules to be triggered. In practice, the precondition that a participation of the selling party has happened, is assumed relatively quick, as it is already sufficient that the seller knows or should know that the acquiring company intends to use the non-operating assets of the acquired company to settle the purchase price.

Pursuant to Art. 671 para. 1 Code of Obligations (CO) the legal reserves have to amount to 50% of the share capital of a Swiss AG. Accordingly, the legal reserves in the amount of CHF 100’000 of QuickShip AG cannot be distributed. Accordingly, the retained earnings of QuickShip AG in the amount of CHF 5’700’000 are distributable. Based on the balance sheet QuickShip owns assets of CHF 6’100’000 of which CHF 4’100’000 are non-operational assets. As only non-operational assets are relevant for the indirect partial liquidation the relevant assets amount to CHF 4’100’000. As the purchase price of CHF 10m is higher than the amount of CHF 4’100’000, the amount of CHF 4’100’000 is decisive for the indirect partial liquidation. Considering the marginal income tax rate of Mr. Seagull, the potential income tax consequences could amount to CHF 1’025’000 in case an indirect partial liquidation is triggered (excl. late payment and compensatory interests) (cf. Solution File Case 2 Step 1).

In our case the granting of the loan by Mr. Seagull is a strong indicator for an active participation of Mr. Seagull in the distribution of the non-operating assets after the transaction. In principle, it is not required that the shares in QuickShip AG are transferred against a loan granted by Mr. Seagull to FlyByU Holding AG for the rules on the indirect partial liquidation to be triggered. Also in case the purchase price would directly be settled in cash by FlyByU Holding AG an indirect partial liquidation could potentially be triggered, if FlyByU Holding AG distributes non-operating assets from QuickShip AG within five years as in practice the preconditions under which a (passive) participation of the selling party is assumed are very low.



Step 2 – Additional partner questions

Mr. Seagull should assess whether the acquiring party will hold the shares as private assets or as business assets. However, in case of a transfer to a corporation or a partnership, the precondition that the shares are transferred from private assets to business assets will always be fulfilled. Further, he should know that in case less than 20% of the shares are sold, no indirect partial liquidation could be triggered. On top of that he should pay attention to the fact that partial sales during the five-year blocking period will be summed up and seen as one transaction.

Once the shares in QuickShip AG are acquired by FlyByU Holding AG, Mr. Seagull can no longer control distributions by QuickShip AG. Mr. Seagull should, therefore, insist on an indemnity clause in his favor in the share purchase agreement for the case that the acquiring company should trigger an indirect partial liquidation.

Step 3 - Email to Mr. Seagull

Deferred tax expense calculation

You
To Dominik Bischof

Reply | Reply All | Forward | ...

Dear Mr. Seagull,

Thanks for your voicemail.

To summarise: You want to sell your shares to FlyByU Holding AG, which is part of FlyByU Group, and a client of ours. If I would assist you in this request, I would create a severe conflict of interest for myself and PwC as I act as consultant for both parties of the transactions.

Such situations should immediately be addressed with the responsible manager Dominik and the responsible partner Markus to avoid a conflict of interest.

Therefore, I would like to ask you for more time, so we can assess the situation and consult our Office of the General Counsel.

Thank you for your patience.

Kind regards,
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