Still going strong, but for how long?

Dr Christoph Neeracher and Dr Raoul Stocker of Bär & Karrer assess the impact of recent legal and market developments in Switzerland, and future prospects

In contrast to most other Western European economies and despite a difficult market environment, the Swiss economy has managed to stay in relatively good shape thus far in 2012, with an expected GDP growth of 1.4% according to the State Secretariat for Economic Affairs. The Swiss Market Index, Switzerland's blue-chip stock market index, has risen by more than 9% since the beginning of the year.

Once again, Switzerland has confirmed its status as a fairly safe haven in turbulent times. The reasons are many. In addition to a stable political system, a liberal economy, a highly educated workforce, and a sophisticated and efficient legal environment, Switzerland's traditionally mild tax regime for both corporations and individuals provides a competitive advantage over its European neighbours. In fact, Switzerland is rated as the most competitive economy in the world in the World Economic Forum's Global Competitiveness Report 2012/13.

M&A

The good shape of the Swiss economy is reflected in the domestic M&A market. The first quarter of 2012 saw a significant deal flow.

> "The initiative might strip private equity firms of an incentive tool to improve the performance of their portfolio companies"

Nevertheless, after this promising start, the EU sovereign debt crisis started to have a negative impact on the Swiss M&A market. Compared to the first quarter of 2012, the second quarter showed a decrease of 11% in deal numbers and almost 66% in deal volume, according to Ernst & Young. The latter figure, however, was largely due to the Glencore/Xstrata deal. Without this transaction, the second quarter looks much brighter and even saw a slight increase of 8% in deal volume. According to KPMG, the total transaction volume for the first half of 2012 amounts to $83 billion, which represents a 47% increase compared to the same period in 2011.

The outlook for the rest of the year remains cautiously optimistic according to both Ernst & Young and KPMG, with overall M&A activity forecast to remain stable at Q2 2012 levels, both in terms of deal numbers and volume.

Further deals are expected in the commodities and financial services sectors. Particularly in the private banking sector, many small players have come under considerable margin pressure, which is expected to lead to further consolidation. In term of deal numbers, the most active sector in the first half of 2012 was, however, once again media, technology and telecommunications. The SFr2 billion ($2.1 billion) purchase of Orange Communications, a Swiss mobile operator, by Apax Partners is a standout example.

Mainly due to large cash reserves and the relative strength of the Swiss franc, today Swiss firms act more often as buyers than as sellers. According to a study by KPMG, Swiss companies acted as buyers in 67% of the domestic and international M&A transactions with a Swiss participant in recent months.

Private equity and venture capital

According to the *Global Private Equity Barometer* provided by Coller Capital, the global importance of private equity is widely expected to rise within the next three to five years.

The existing market situation in Switzerland does not necessarily lead to much optimism, however. While the balance sheets of Swiss private equity firms are generally in good shape, attractive PE targets are fairly scarce, especially in the primary market. The prospects for the secondary market look somewhat brighter, as many banks and insurance companies are looking to clean up their balance sheets in order to comply with new regulatory requirements. Distressed debt is a further performance driver.

Two main factors are putting a certain strain on private equity. Firstly, in the competition for targets, banks no longer favour financing private equity over strategic investors. Banks have become increasingly cautious when it comes to lending. Consequently, private equity firms are increasingly losing out to cash-rich corporate bidders on many deals that they might have secured a few years ago. Secondly, a historically strong Swiss franc makes acquisitions in Switzerland more expensive than in the Eurozone, especially as a large number of the private equity houses hold euro-denominated funds.

Despite a favourable legal and tax environment and several governmental and non-governmental initiatives to support the industry, the Swiss venture capital sector has not (yet) lived up to the expectations, as both deal numbers and volume remain low. The market is heterogeneous and the available data scarce.

The main complaint of investors with respect to the Swiss venture capital market is its slow deal flow, as there generally aren't enough interesting targets. Apart from the fact that Switzerland is a small country, a certain culturally embedded risk aversion might contribute to this assessment.

Corporate

In December 2007, the Swiss Federal Council presented a first proposal for a comprehensive amendment to the Swiss stock corporation and audit law. In a nutshell, the amendment aims at improvement of corporate governance, higher flexibility in capital structures, modernisation of the general assembly, and reorganisation of the accounting and financial reporting law.

A key element in the area of corporate governance is the expansion of shareholder rights at all levels. In the proposals, information rights of shareholders are strengthened by granting them the right to submit a written information request at any time, which the board must answer within

60 days. The organisation of the board is modified by, among other things, reducing the office term for board members to one year. Share capital increase or reduction procedures are simplified in order to achieve a more flexible capital structure and to allow companies to faster adapt their capital structure to the market. Electronic devices, in particular video conference, are expressly permitted for the preparation and execution of general assemblies. The accounting and financial reporting regulations are unified for all legal forms of companies. Under the new rules, there is a differentiation according to the size of a company rather than to its legal form.

Two months after the release of this proposal, Thomas Minder, a member of the Swiss parliament, submitted a popular initiative "against fat-cat salaries" (*"Abzockerinitiative"*). This initiative, which would, it should be noted, apply only to Swiss public companies, calls for extensive new mandatory rules on transparency and compensation of board members and senior management. Under the initiative, shareholders are allowed to vote on the total remuneration of board members and of the senior management on an annual basis. Golden parachutes and payments in the event of company sales would be prohibited. In case of breach, the initiative provides for different penal sanctions with prison sentences of up to three years in severe cases.

A lengthy parliamentary debate and public discussion on corporate law followed this proposal. While the revision of the stock corporation legislation was put on hold until the popular vote on the initiative (expected to take place in the beginning of 2013), the amendments concerning financial reporting have been finalised and will shortly enter into force.

As it is not yet clear if, and in what form, the popular initiative will be accepted, it is impossible to assess what effects the future regulations will have on the market. In particular, the harsh penal provisions of the initiative are, however, expected to have a negative impact on the competitiveness of the Swiss economy, should they actually be imposed. The initiative could also have adverse effects on private equity in particular: private equity firms routinely grant compensation to the management of their portfolio companies if these companies can be sold with a benefit. As the initiative text prohibits sale and purchase incentives, this practice would most certainly no longer be possible, stripping private equity firms of an incentive tool to improve the performance of their portfolio companies.

It should be noted that, despite the many uncertainties surrounding the final provisions, the debate on the future amendment to corporate law has already shown some notable effects: compensation rules and a compensation report have become common in many companies, and several companies have shortened the office terms of their board members to between one and three years.

Private M&A

Two recent amendment proposals regarding Swiss laws are expected to impact the private M&A market.

The first is the amendment to the Cartel Act (CartA). The Swiss Federal Council submitted its proposal concerning this amendment to parliament in February 2012. The amended text aims to ban all forms of horizontal price, output and territorial agreements as well as vertical price and territorial agreements.

Under existing laws, the Swiss Competition Commission (ComCo) has to prove that an agreement restricts competition significantly. Under the proposed amendment, no such proof would be required in case of horizontal price, output and territorial agreements as well as vertical price and territorial agreements. Such agreements would be prohibited and subject to fines even if they intensify competition or if they have not been implemented unless the involved companies could establish that there is a justification for reasons of economic

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Christoph Neeracher specialises in international and domestic M&A transactions (focusing on private M&A and private equity transactions, including secondary buy-outs and distressed equity), transaction finance, corporate restructurings, corporate law, general contract matters (for example, joint ventures, partnerships and shareholders agreements) and all directly related areas, such as employment matters for key employees (including employee participation and incentive agreements).

He is experienced in a broad range of national and international transactions both sell and buy side (including corporate auction processes) and the assistance of clients in their corporate and commercial activities. Additionally, he represents clients in litigation proceedings relating to his specialisation.

Christoph Neeracher is recognised as one of the pre-eminent private M&A and private equity attorneys in Switzerland (*Swiss Equity Magazine*: Private Equity, November 2008) and as a leading lawyer in financial and corporate law (*IFLR 1000*, 2011-2012). Additionally, *Chambers Europe* ranks him as a leader in the field of M&A (2010-2012), who receives effusive praise from clients, one of whom says "he fits very well into our corporate structure" (2011). *The International Who's Who of M&A Lawyers 2012* lists him as one of the world's leading M&A lawyers, and he is also described as being "extremely experienced in M&A matters and very strong in negotiations" (*The Legal 500*, 2012).

Dr Raoul Stocker
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Raoul Stocker heads the tax team of Bär & Karrer. He has broad experience in all taxation matters and advises both corporations and individuals. His main focus lies on corporate tax planning, cross-border structuring of corporate transactions and businesses, and transfer pricing as well as taxation of financial institutions. He is specifically experienced in international tax litigation such as mutual agreement procedures and advanced pricing Agreements.

According to *Chambers Global 2012*, Raoul Stocker has particular knowledge of transfer pricing, taxation of financial institutions and cross-border tax structures. "He has good technical knowledge in Swiss and international tax law and is very successful in negotiating" (*The Legal 500*, 2012).

efficiency. This change would bring a shift from an effects-based to a very formal object-box approach. This shift would especially affect horizontal cooperation, for example purchasing cooperation, production and joint venture agreements where the parties would have to establish clear benefits of their cooperation for customers. Also in the area of vertical restraints, it can be expected that the ComCo would step up its already very formal approach.

The envisaged change to the CartA would also introduce the so-called Significant Impediment to Efficient Competition (SIEC) test in merger-control cases. The test is already used by the European Commission and other authorities. Against the dominance test used today in Switzerland, the SIEC would lower the threshold for prohibiting mergers. It has to be noted, however, that the ComCo has interpreted the dominance test in a very extensive way in some cases. For this reason, the change to the SIEC test would not be expected to bring too much of a shift in practice.

The amendment also aims at strengthening the rule of law through institutional reform. It is intended to create a court that would decide behavioural cases while the ComCo would become a prosecutor with no decision-making power of its own except in merger-control cases. The competition authority would conduct the investigation and move for motion to the competition court (a new specialised antitrust chamber within the Federal Administrative Court).

The second proposal which could impact private M&A is an amendment to the Collective Investment Schemes Act (CISA) which is expected to come into effect at the beginning of 2013. It aims at further adapting the Swiss regulation to international standards, especially to the Alternative Investment Funds Managers Directive (AIFMD), an EU directive expected to come into force by mid-2013 and hence to guarantee a discrimination-free access of Swiss financial service providers to European financial markets. The amendment is furthermore expected to contribute to the quality and reputation of the Swiss financial market and to further improve the protection of investors.

The new EU directive will introduce a common regulation for alternative investment funds (AIF) managers at EU level, which brings far reaching regulatory changes for asset managers of alternative investment funds such as hedge funds and private equity funds. AIF managers which are domiciled or managed in the EU or distribute their shares to professional investors in the EU will be required to obtain an authorisation and be supervised. The AIFMD will be applied on all EU investment advisers of collective investment schemes, who are not already subject to the Undertakings for Collective Investment in Transferable Securities Directive. The management of collective investment schemes can no longer be delegated to investment advisers domiciled in non-EU states which are not subject to an equivalent supervision. It is not yet clear which conditions third-country AIF managers will have to meet in order to obtain a permission to manage EU AIF and to distribute AIF shares in EU member states. The amendment to the CISA tries to increase the probability of securing the delegation of asset management to Swiss asset managers after 2013 and to obtain an EU permission by aligning the management, safekeeping and distribution rules with the AIFMD.

The partial revision of the CISA is expected to make it mandatory for Swiss asset managers to hold a licence from the Swiss Financial Market Supervisory Authority in order to manage foreign collective investment schemes. Accordingly, the new regulation is expected to generate additional administrative costs for these AIF, which might become an issue, especially for small and mid-sized companies. It could also keep hedge fund managers from relocating to Switzerland.

Tax laws

Several new pieces of tax legislation entered into force since last year or will most likely enter into force within the next year.

As from January 1 2011, any repayment of reserves built up by a company from capital contributions made by the shareholders (including share premium and informal capital contributions) after December 31 1996 is treated in the same way as the repayment of nominal share capital. Such repayments are not subject to income tax in the hands of private individuals and are exempt from federal dividend withholding tax according to Swiss law.

In order to qualify for tax-free repayment or distribution, the reserves must be disclosed in the company's balance sheet, and they must originate from contributions made by the shareholders. The tax-free distribution of such reserves requires that the reserve stems from capital or surplus contributions made by the shareholders after December 31 1996 and is reflected in a separate reserve account in the balance sheet, provided further that any fluctuations are regularly reported to the Swiss Federal Tax Administration (SFTA). The capital contribution principle is being discussed in the Swiss parliament. It is highly uncertain whether new rules will be implemented to restrict re-payments of capital contribution reserves.

> **"The Competition Commission would become a prosecutor with no decision-making power of its own except in merger-control cases"**

Since the introduction of the capital contribution principle as of January 1 2011, a new alternative to the inbound migration in the narrower sense is the quasi-merger transaction, whereby the shareholders first reorganise their foreign target company abroad and have it establish a Swiss subsidiary to which they contribute the shares of the foreign target entity or of significant subsidiaries in exchange for new shares in the Swiss company, which may eventually be distributed to the ultimate shareholders. The contribution of qualifying investments to the Swiss company and the issuance of Swiss shares in return are exempt from Swiss stamp duties and the contributing shareholders are basically free to define the equity capital structure of the Swiss company: the entire net value of the contribution may be reflected as a combination of nominal share value and share issuance premium, which is eligible for tax privileged treatment as "capital contribution reserve" (regardless of the retained earnings of the underlying entities). No Swiss withholding tax or income tax applies to the repayment or distribution of such equity funds to the shareholders.

A new Federal Act, the Swiss Tax Law on Employee Participations, will provide a legal basis for the taxation of financial benefits derived from employee participations, and is intended to offer long-awaited legal certainty and ensure uniform taxation across the Cantons. The new legislation will enter into effect as of January 1 2013, and the forms of employee participations most frequently used in practice will be taxed as follows:

Freely disposable as well as blocked employee shares will be taxed at the moment of acquisition. In the case of a blocking period, a reduction on the market value may still be claimed for income tax purposes. This conforms to today's practice.

"A new Federal Act is intended to offer long-awaited legal certainty and ensure uniform taxation"

Listed and freely disposable employee stock options are taxed at the moment of their acquisition, analogously to the rules applicable to employee shares. This conforms to present practice. Non-listed or blocked employee stock options are now newly taxed at the moment of exercise. Reductions on the market value of blocked employee stock options will no longer be granted for the purposes of income tax.

Artificial employee participations which do not provide for an allocation of ownership rights qualify as mere cash compensations and are taxed at the moment of payment or accrual. This assessment basis applies to both the federal income tax as well as the cantonal and municipal taxes.

Employee stock options which must be purchased within a defined period of time in order to be exercised (definitive acquisition of title) are to be taxed proportionally, if the domicile or residence for tax purposes was not in Switzerland during the entire period between acquisition and accrual of the right to exercise. In this regard, the financial benefit is to be taxed pro-rata in relation to the total time period spent in Switzerland. If the employee stock options are exercised by a beneficiary domiciled outside Switzerland who was domiciled in Switzerland at the time of allocation, Switzerland has a right to pro-rata taxation which is exercised by way of taxation at source.

Tax treaties

Switzerland and Germany have initiated a tax treaty which regulates the investment income and capital gains of German bank clients in Switzerland. The treaty includes a final withholding tax for the future and taxation assessed in arrears. In future, the investment income and capital gains of German bank clients will be taxed at a uniform rate of 26.375% in Switzerland. Fundamentally, this means that the tax obligation towards Germany as state of residence is fulfilled. The taxation assessed in arrears is a one-time tax of between 21% and 41% of the asset, whereby the applicable tax rate depends on the duration of the client relationship as well as the opening and closing balance of the total capital. This tax does not have to be paid if the client discloses his/her Swiss bank relationship to the German authorities. The treaty additionally allows the German authorities to file between 750 and 1300 information requests within the first two years if there is reasonable cause. These requests must include the name of the client; it is not mandatory to include the name of the bank. Whether the treaty will enter into force on January 1 2013 is highly uncertain due to opposition in Germany.

Switzerland and the United Kingdom have signed a treaty regarding cooperation in tax matters. In accordance with this treaty, taxpayers residing in the UK may legalise their existing bank relations in Switzerland either by a one-time tax payment or the disclosure of their accounts. The future investment income and capital gains of UK bank customers in Switzerland are subject to a final withholding tax, the proceeds of which Switzerland will forward to the UK authorities. The treaty will enter into effect on January 1 2013.

Switzerland and Austria have signed a tax treaty which deals with the same matters as the treaties signed with Germany and the United Kingdom. The taxation assessed in arrears is a one-time tax of between 15% and 38% of the asset, whereby the applicable tax rate depends on the duration of the client relationship as well as the opening and closing balance of the total capital. In future, the investment income and capital gains of Austrian bank clients will be taxed at a uniform rate of 25% in Switzerland. The treaty will probably enter into effect on January 1 2013.

Financing

In a change of practice, the SFTA, as per July 26 2011, has eased the requirements under which companies which continuously accept money and funds at interest but do not qualify as a bank in accordance with the Swiss Banking Act qualify as a bank for Swiss withholding tax purposes. The threshold of 20 non-bank lenders has been raised to 100 and the total debt is now to amount to at least SFr5 million. These criteria are to be fulfilled cumulatively. This change of practice of the SFTA facilitates (external) debt collection services as well as the cash pooling of affiliated companies. Hence, customer credit balances between affiliated companies no longer trigger any withholding tax obligation (article 14a of the Swiss Withholding Tax Ordinance). If a domestic affiliated company guarantees a debt security of a foreign affiliated company and thus loses the withholding tax privilege of affiliated companies, there will still be no withholding tax obligation if a Swiss company does not have credit at more than 100 affiliated companies. There have been no changes with respect to the practice for money market instruments. Accordingly, a withholding tax obligation applies to serial money market instruments and book claims (bonds) bearing a total debt exceeding SFr500,000 towards more than 10 non-bank lenders. For continuously issued money market instruments and medium-term bonds, the requirements remain the same as previously: more than 20 non-bank lenders and a total debt of SFr500,000 is required.

In relation to the revision of the Swiss Banking Act and with a view to the strengthening of the stability of the finance sector, parliament decided in September 2011 to repeal the issuance stamp duty on bonds and money market instruments and to exempt the conversion of bank contingent convertible (or CoCo) bonds from the issuance of a stamp duty. The amendments entered into force on March 1 2012. They will facilitate the strengthening of the equity capital base of systemically relevant banks, especially in view of the issuance of CoCo bonds.