Gaining momentum

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

Despite a persistent recession in parts of the eurozone, the Swiss economy has been performing strongly thus far in 2013, 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, reached its highest level since 2007 in March 2013 and has risen by an impressive 17% since the beginning of the year.

It is no surprise that Switzerland is once again rated as the most competitive economy in the world in the World Economic Forum's Global Competitiveness Report 2013/14. Switzerland's stable political system, liberal economy, highly educated workforce, sophisticated and efficient legal environment, and traditionally mild tax regime all contribute to an excellent business environment and provide a competitive edge over other economies.

M&A market

The domestic M&A market has not managed to repeat its promising start of the previous year, and is currently lagging behind an otherwise positive Swiss economic performance. Compared to the first quarter of 2012, the first quarter of 2013 saw a significant decrease in both deal numbers and volume according to Ernst & Young. The second quarter brought no recovery. While the deal number slightly increased, the deal volume dropped by 14% compared to the first quarter, and fell to its lowest level since 2008. The main reason for these figures is the lack of large transactions in the first half of this year.

The outlook for the rest of the year remains cautiously optimistic according to KPMG, with overall M&A activity forecast to remain stable in the third quarter and a possible recovery in the fourth quarter of 2013.

Further deals are namely expected in the consumer market, energy and financial services sectors. In particular, regulatory changes are expected to foster a further consolidation in the energy and private banking sectors. Larger banks and consumer market companies are likely to sell non-core assets in order to put a stronger focus on their core business areas. The same applies to the chemical sector, as illustrated by Clariant's recent sale of its textile, paper and emulsions businesses to SK Capital. In term of deal numbers, the most prolific sector in the first half of 2013 was industrial goods and services.

Mainly due to the economic recovery in the US and in Asia, and a difficult market environment in the eurozone, Swiss firms now focus on target companies located outside of Europe. According to a study by KPMG, deals involving North American targets have become increasingly frequent since mid-2012.

Private equity and venture capital market

According to the *Global Private Equity Barometer* provided by Coller Capital, investors are expected to regain confidence and to raise their private equity target allocation over the next year.

However, Swiss market developments have not yet reflected such an upward trend. While the aggregated number of deals in Switzerland, Germany and Austria slightly increased in the second quarter, the deal volume declined and is now lower than in the final quarter of 2012. Factors such as a comparatively strong Swiss franc, which makes acquisitions in Switzerland more expensive than in the eurozone, and difficulties in fundraising are putting a certain strain on private equity.

Nevertheless, the outlook for the rest of the year remains cautiously optimistic, as many companies have published good results and private equity firms are eager to diversify their portfolios. As investors such as banks and insurance companies are still looking to clean up their balance sheets in order to comply with new regulatory requirements, secondary market activity is expected to remain at or even exceed the high level reached in 2012.

Both deal numbers and volume remain low in the Swiss venture capital sector despite a favourable legal and tax environment. Experts name the scarcity of Swiss-based venture capital investors as one of the main reasons for this low. The relatively small market size and a certain culturally embedded risk aversion make positive changes rather unlikely, despite interesting Swiss targets, in particular in the life science and internet sectors.

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.

Meanwhile, the amendments concerning financial reporting were finalised and entered into force in January 2013. Under the new rules, the accounting and financial reporting regulations are unified for all legal forms of companies. The new regime differentiates according to the size of a company rather than to its legal form.

In March 2013, a popular initiative against fat-cat salaries (*Abzockerinitiative*) was approved by the Swiss voters. This initiative, applying only to Swiss public companies, calls for extensive new mandatory rules on transparency and compensation of board members and senior management:

- The aggregate compensation of the board of directors and the senior management will be subject to the approval of the general meeting of shareholders;
- Severance payments (golden parachutes), advance payments and similar extraordinary payments to directors or senior managers, as well as multiple contracts between directors and senior managers and group companies will be prohibited;
- The articles of association will have to include rules for directors and senior managers on loans, retirement benefits, incentive and participations plans, and the number of positions outside the group;
- The chairman of the board, the board members, the members of the board's compensation committee, as well as the independent proxy will have to be elected annually by the general meeting of shareholders; and
- Companies will no longer be allowed to act as corporate proxies but will need to allow shareholders to cast their votes electronically from a remote location.

The implementation of the popular initiative into Swiss law is being prepared. Therefore, it is not yet possible to assess what effects these future regulations will have on the market. 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 new regulations could also have adverse effects on private equity in particular: private equity firms routinely grant compensations to the management of their portfolio companies if these companies can be sold with a benefit. As the initiative text

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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.

Private M&A

Two recent developments regarding Swiss laws are expected to impact the private M&A market. The first is the proposed amendment to the Cartel Act (CartA). The Swiss Federal Council submitted its proposal concerning this amendment to parliament in February 2012, where it is currently pending. Among others things, it plans to introduce a so-called Significant Impediment to Efficient Competition (SIEC) test in merger-control cases. The European Commission and other authorities already use the test. Against the dominance test currently used 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 broad 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 second is an amendment to the Collective Investment Schemes Act (CISA), which came into effect on March 1 2013 (and some provisions on June 1 2013). It aims at further adapting the Swiss regulation to international standards, especially to the Alternative Investment Funds Managers Directive (AIFMD) and hence to guarantee a discrimination-free access of Swiss financial service providers to European financial markets. The amendment is further expected to contribute to the quality and reputation of the Swiss financial market, and to further improve the protection of investors.

The AIFMD introduces 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 are or will soon be required to obtain an authorisation and be supervised. The AIFMD applies to all EU managers 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 still not 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 amendments to the CISA together with the Swiss Financial Market Supervisory Authority (FINMA)'s signing of cooperation agreements with several EU and EEA states were undertaken to increase the probability of securing the delegation of asset management to Swiss asset managers after 2013, and to align the management, safekeeping and distribution rules with the AIFMD.

The partial revision of the CISA makes it mandatory for Swiss asset managers to hold a licence from FINMA in order to manage foreign collective investment schemes and is expected to generate additional administrative costs and higher running expenses for these AIF.

Author biographies

Christoph Neeracher
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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 buyouts, public to private transactions and distressed equity), transaction finance, corporate restructurings, relocations, corporate law, general contract matters (such as joint ventures, partnerships and shareholders agreements) and all directly related areas such as employment matters for key employees (for instance 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 ongoing corporate and commercial activities. Additionally, he represents clients in litigation proceedings relating to his specialisation.

He 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).

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 2013*, Stocker is 'straightforward and to the point' and 'has excellent ties with the tax authorities'. *Chambers Global 2012* pointed out his 'particular knowledge of transfer pricing, taxation of financial institutions and cross-border tax structures'. *The Legal 500, 2013* recommends Raoul Stocker for his experience in negotiating with tax authorities and his deep knowledge of national and international tax. He is 'the leading Swiss Transfer Pricer' according to the *Guide to the World's Leading Transfer Pricing Advisors*.

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Charles Gschwind is an associate at Bär & Karrer and member of the private M&A and real estate practice teams. He focuses on M&A transactions as well as general contract, corporate and commercial matters, and has gained particular experience in large scale real estate transactions.

Tax laws

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

A new tax law that entered into force as of January 1 2013 provides a legal basis for the taxation of financial benefits derived from employee participations. Aimed at offering long-awaited legal certainty and ensuring uniform taxation across the Cantons, the new legislation has been supplemented by the Swiss Federal Tax Authority (SFTA) with a Circular Letter (number 37), detailing various aspects of the new provisions. The following taxation rules apply to the forms of employee participations most frequently used in practice:

- Freely disposable as well as blocked employee shares are taxed at the moment of acquisition. Where a blocking period exists, the market value is discounted for tax value determination (6% per blocking year).
- Listed and freely disposable employee stock options are taxed at their acquisition, analogously to the rules applicable to employee shares. Non-listed or blocked employee stock options are taxed at the moment of exercise.
- 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.
- Employee stock options that must be purchased within a defined period of time to be exercised (definitive acquisition of title) are 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. Where an individual has moved abroad and exercises employee stock options acquired during (part of) his former period Swiss tax residency, Switzerland has a right to pro-rata taxation via taxation at source. Swiss-based companies need to take these obligations into account in their tax compliance.

Tax treaties

In November 2012, the German Parliament rejected a new tax treaty negotiated between Switzerland and Germany regulating the investment income and capital gains of German bank clients in Switzerland. Consequently, international tax matters between Switzerland and Germany remain to be solved on the basis of the existing double taxation treaty (DTT) dated 1971.

As of January 1 2013, the double taxation treaty (DTT) between Switzerland and the UK, as well as the DTT with Austria entered into force. Based on them, taxpayers residing in the UK or in Austria may legalise their existing bank relations in Switzerland either by a one-time tax payment or the disclosure of accounts. Their ongoing investment income and capital gains in Switzerland are subject to a final withholding tax, the proceeds of which Switzerland forwards to the UK or Austrian authorities.

As of July 2013, 85 DTTs concluded by Switzerland were in force, a further three had been signed and a further four had been initiated. The following amended or revised DTTs are applicable as of January 1 2013: the DTT with Turkey and the DTT with Malta. The exact date of applicability of the revised DTT with Portugal has not yet been published.

On August 29 2013 the US Department of Justice and the Swiss Federal Department of Finance signed a joint statement aimed at bringing an end to the long-lasting tax dispute over undeclared assets and income of persons taxable in the US and invested in Swiss bank accounts. The programme "does not apply to individuals and is not available to any Swiss bank as to which the US Justice Department's Tax Division has authorized a formal criminal investigation concerning its operations". Based on the programme Swiss banks that are not the subject of a criminal investigation of the US Department of Justice can obtain a resolution concerning their status in connection with the Justice Department's overall US tax evasion investigations. Accordingly, Swiss banks are classified into four categories (depending on their level of client relationship with non-compliant persons taxable in the US) for which different programme requirements are set out. Despite the fact that the final solving of every single case will take time, the joint statement allows Swiss financial institutions with client relationships in the US to obtain long-awaited legal certainty.

International administrative assistance in tax matters

The new Tax Administrative Assistance Act (TAAA) regarding Switzerland's administrative assistance in international tax matters entered into force as of February 1 2013. The TAAA governs the execution of administrative assistance in accordance with DTTs and other international agreements providing for the exchange of information regarding tax matters and may be overridden by contradicting provisions of an applicable DTT. Switzerland continues to only grant international administrative assistance in tax matters based on a detailed demand (no automatic exchange of information).

Push-down of acquisition debt

Mergers in Switzerland may be conducted in a tax-neutral way if: (i) tax liability remains in Switzerland; and (ii) the tax values are continued. However, based on the so-called tax avoidance doctrine, Swiss tax authorities may deny tax-effective deduction of interest upon merger of the acquisition vehicle with the target. Tax avoidance is assumed when the chosen structuring is uncommon, inappropriate or doesn't make sense economically, when tax savings are the only reason for the structuring and if substantial tax savings were to result from the structuring, were it accepted. The risk of tax authorities assuming tax avoidance is higher if an acquisition vehicle (i.e. SPV) is involved in the transaction than if the acquiring company is an operating company.

To eschew the tax avoidance doctrine alternative debt push-down strategies have been developed while securing (at least partially) the same goal: tax effective deduction of interest. Cascade purchases are considered in cases where a complex structure is acquired. The acquisition company acquires only a single company within the target structure, which then in turn acquires another company in the structure, and so on. This allows for positioning the bank loans in operating companies, whose assets provide sufficient collateral and enables interest deduction for profit tax purposes. However, this method can lead to complex and impractical final structures. To simplify the structure, a merger of all the companies in the structure is needed (possible problems: loss on merger and adverse balance). In a so-called equity debt swap, reserves of the target company are distributed to the acquiring company after the former has decreased its capital, which in turn allows the latter to repay its acquisition loan towards the bank. The bank then grants a loan to the target company, with the target company's assets serving as collateral, leading to the desired situation of placing the loan and security package in the same company and enabling a tax effective deduction of interest by the target company. This strategy is negatively impacted by the fact that there is often only a small amount of distributable reserves in the target company. Also, equity rules (thin capitalisation) have to be followed, as well as cases considered in which an indirect partial liquidation is assumed, and accordingly triggers adverse income tax effects (if the target company is held as a private asset by the seller).

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