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Indirect Partial Liquidation

Legal Situation in Switzerland

Swiss resident individuals selling shares in a corporation held as private assets generally realize an income tax-free capital gain (or non-tax deductible loss). Income from capital (such as dividends and interest), however, is partially or fully taxable for them. In case of an indirect partial liquidation (IPL), proceeds from the sale of privately held shares are re-characterized from tax exempt income into taxable dividend income at the level of a Swiss resident individual seller.

Qualifying Criteria for an IPL

Swiss tax resident individuals will be taxed under the IPL regime if the following conditions are cumulatively met:

a) sale of participations of at least **20% in the share capital** of a Swiss or foreign target corporation which are held as private assets by the sellers and as business assets by the acquirer (the 20% threshold can also be reached by joint sales of Swiss resident individuals or sales over a period of five years);

b) at the date of the sale, the target company has **distributable reserves** (from a commercial law perspective);

c) as of the date of sale, the target group has **non-business required assets**, such as cash, securities, real estate (to the extent the latter is not required from an operational perspective), which could have been distributed to the seller prior to the share sale;

d) **within five years** after the share sale, the target company actually distributes non-business required assets to the acquirer, which already existed and were distributable at the time of sale; and

e) the **seller has co-operated with the acquirer** to have such assets distributed. This requirement is interpreted extensively such that, in practice, the mere fact of a distribution according to letter d) usually leads to the assumption that such co-operation was given and that the seller could have anticipated such distribution.

Tax Consequences

Should an IPL be triggered due to such distributions after the sale, the proceeds from the sale of the share are retroactively qualified as taxable dividend income of the seller.

The tax basis in case of an IPL is the lowest of a) the purchase price, b) the distributable reserves of the target at the time of the sale, c) the non-business required assets and d) the actual distribution. Post-acquisition reorganizations like a merger between the target company and the acquisition vehicle generally qualify as a distribution. Upstream loans or guarantees by the target group can also qualify as detrimental distribution if the repayment of the loan is at risk or the enforcement of a guarantee is likely.

In order to avoid these tax consequences, a seller usually includes an IPL clause in the share purchase agreement (SPA). It usually includes contractual restrictions during five years for the acquirer in

terms of post-closing structuring/distributions and an indemnity for the seller's income tax consequences in case of a breach.

Pre-Closing Risk Mitigation

The potential IPL exposure may be mitigated or reduced in its amount with a dividend distribution (taxable for the seller) before closing, which is to be negotiated between seller and acquirer in order to reduce the amount of distributable reserves. Alternatively, non-business required assets can be used to repay debt or for investments to evidence that the target group only possesses business required funds.

IPL Structuring

Even if an IPL clause is agreed in the SPA, the acquirer typically has certain possibilities to use funds of the target after the closing without triggering an IPL taxation for the seller:

a) Dividend distributions out of ordinary profits earned in the year of the transaction and following years are principally not considered as harmful distributions;

b) Provision of intercompany loans by the target company at arm's length terms and interest rates and where the repayment is not at risk is generally not considered as harmful distribution;

c) Pledging of the shares in the target company is principally not considered a harmful distribution;

d) Mergers of group companies (side stream) with the target company are generally not considered as harmful, however the IPL restrictions continue to apply.

IPL Tax Ruling

It is recommended to confirm the conditions of the IPL in a tax ruling with the competent tax authority for the seller. The tax authority generally confirms the lack of non-business required assets, the maximum exposure (distributable reserves) and the end of the five year period. Further, intended actions by the acquirer after the sale should be addressed to confirm that they would not trigger the IPL taxation. The IPL clause in the SPA should allow the acquirer to file such tax ruling.

Please note that this briefing contains only a generic overview and does not purport to be comprehensive, nor a detailed advice for any specific case that might arise.

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