

Important Supreme Court Ruling Confirming Tax Free Step-Up

The Federal Supreme Court has on 18 February 2014 rendered an important ruling on the tax-neutral step-up of hidden reserves of a Geneva-based holding company. The hidden reserves had been created while the holding company enjoyed an income tax exemption under the cantonal holding company regime. After the company had changed its tax status into an ordinarily taxed company, it sold some of its assets at a considerable gain. In its corporate tax return the company deducted losses from earlier periods from the realized capital gain and thus reported zero taxable profit.

The Supreme Court confirmed the approach taken by the Geneva Cantonal Tax Authorities and the cantonal courts that losses accrued during the period of the exempt tax status could not be deducted from profits realized after the corporate tax exemption had fallen away. However, the Federal Supreme Court also confirmed the tax practice of a majority of the cantons allowing a tax-neutral step-up of hidden reserves that were built up while a cantonal tax privilege applied (hence the expense for the creation of the hidden reserves was not tax effective, due to the tax privilege) upon the termination of the privileged corporate tax status as being appropriate. Under that practice, tax-neutrally created hidden reserves may be released tax neutrally upon termination of the tax privileged corporate tax status, at least to the extent of the depreciation expense that could not be deducted tax-effectively while the exemption from profits tax applied.

This now confirmed cantonal practice of allowing a tax-free step-up of assets with hidden reserves that were built up while the company enjoyed a cantonal tax privilege (such as a holding regime or a cantonal domicile company, administration company, mixed company, auxiliary company or similar regime) is very important and provides some relief in view of the upcoming IIIrd Business Tax Reform against the backdrop of the OECD's BEPS initiative and pressure from the EU on the Swiss cantonal corporate tax privileges. It is generally viewed as certain that these cantonal tax regimes will be abolished over the next

few years. Although certain replacement measures such as licensing boxes, interest deductions on equity capital etc. are being considered, there is a substantial risk that especially international trading companies, which at present can benefit of cantonal "mixed company" or "auxiliary company" tax regimes will be facing substantially higher cantonal tax charges once the regimes will have been abolished. The possibility for a tax-neutral step-up, i.e. release of hidden reserves built up against the taxable profits while the reduced cantonal tax rate applied, upon the entry into the ordinary cantonal tax regime will at least provide some temporary relief against the higher cantonal tax burden going forward. The tax-neutral step-up of tax values of depreciated assets will provide the company additional opportunities to again depreciate the assets against taxable profits over a number of years during which the increased cantonal tax rate will be applicable.

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