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Swiss Tax Case Report – August 2022

Swiss Supreme Court Denies Participation Deduction on Sale of a Minority Shareholding

The Swiss Federal Supreme Court recently confirmed a ruling of the Administrative Court of the Canton St. Gallen, which had denied a Swiss corporation the application of the participation deduction to a capital gain realized by the taxpayer upon the sale of a 3.14% equity stake in a stock exchange listed company. The taxpayer had unsuccessfully argued that it should be granted the tax relief, as it had originally held an equity stake of over 10% in the target company prior to the partial sale (Supreme Court judgment 2C_950/202 dated 17 December 2021).

Facts of the case

At the beginning of the tax year 2014 the corporate taxpayer had owned 10.86% of the shares of the stock exchange-listed company A. As of 30 April 2014, the taxpayer sold a portion of its investment in A., equivalent to an equity stake of 3.14% to an independent third party. The partial sale generated a book gain of over CHF 49.5 million. The taxpayer also received dividends of over CHF 3.5 million during the same tax year. In its corporate tax return for the federal income tax, the taxpayer claimed the participation deduction for both the dividend received and the book gain realized from the partial sale of its investment in company A. The cantonal taxes were not at stake, as the taxpayer had benefited of a cantonal tax exemption as a holding company. (That exemption was meanwhile abolished; nowadays the same participation deduction would apply at the cantonal tax level es well.) Upon review of the tax return, the cantonal tax authority, in addition to some further adjustments, disallowed the application of the participation deduction with regard to the realized book gain, on the basis that the share sale in question concerned an equity interest of less than 10%. Appeals of the taxpayer against that assessment remained without success, regardless of the fact that the taxpayer had originally held an equity interest in excess of 10% in company A.

Legal analysis and considerations

The Swiss corporate tax systems principally adopts the system of economic double taxation of corporate profits, whereby net profits are first taxed at the corporate level, while upon distribution of the profits to the shareholders, the dividend is again taxed at the shareholder level. That system is however mitigated to some extent in order to prevent

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multiple taxation at various levels. In particular, dividends derived by a corporate shareholder from a substantial corporate investment are relieved from tax through the "participation deduction", which essentially consists of a reduction of the shareholder level tax in the proportion between qualifying "participation income" and the total net income of the corporate shareholder. Thus, the Swiss tax system does not provide for an outright exemption from tax of qualifying investment income, even though the economic effect of the "participation deduction" is usually equivalent to a tax relief for 95-100% of qualifying dividends and gains.

Qualifying "participation income" includes

a) *Dividends* from corporate investments, which *either* represent an equity interest of at least 10% in the underlying Swiss or foreign company, *or* entitle the receiving entity to a share of at least 10% in the profits and reserves of the underlying company, *or* have a fair market value of at least CHF 1 million; and
b) *Capital gains* from the sale of corporate equity investments, which (i) represent an equity interest of at least 10%, *or* a share in the target company's profits and reserves of at least 10%, *and* (ii) were held for a period of at least one full year by the selling taxpayer (art. 70 para. 4 letter b., first part Direct Federal Tax Act, DFTA). The second part of art 70 para. 4 letter b DFTA provides as follows: "*If the (equity) participation quota falls below 10% due to a partial alienation, the [proportional] tax reduction may be claimed for any subsequent alienation gain only, if the remaining participation as of the end of the tax period preceding the sale still has a market value of at least CHF 1 million.*"

Furthermore, art. 70 para. 4, letter a DFTA defines eligible capital gains as the excess of the sale proceeds over the original acquisition cost of the investment.

The legal dispute at hand was about the exact interpretation of art . 70 para. 4, letter b DFTA. The key issue was whether the sale of an equity interest of less than 10%, out of a total investment that initially exceeded 10% of the target company's equity entitled the corporate seller to claim the participation deduction for the capital gain realized from such partial sale. In the case at hand, it was evident and undisputed that prior to the sale of the 3.14% equity interest, the taxpayer had never sold any (partial) interest in the same target company of more than 10%.

The Supreme Court referred to the majority of Swiss legal commentators, who stress that according to the wording of the law. the tax relief for capital gains requires not a holding of at least 10% (originally 20% prior to a reform of the law), but rather an alienation/sale of at least a 10% equity interest. However, certain Swiss scholars have

maintained that it should suffice for the application of the participation deduction that the selling shareholder had once (and for at least one full year) held a qualifying interest of at least 10% (and worth at least CHF 1 million), even if the actual sale at stake was for less than 10% (or less than CHF 1 million). The Federal Supreme Court dismissed those views. Rather, the Supreme Court confirmed the interpretation given by other Swiss scholars to the statutory provisions, which it called a "transaction-based approach": The principle of "conditions once having been fulfilled, considered fulfilled forever" should be limited to the situations where in a first step, an equity investment of at least 10% and held for at least one full year *is sold*, and the remaining investment after such (partial) sale has a market value of at least CHF 1 million at the end of the tax year preceding the next sale of the entire remaining investment (of less than 10%), or a portion thereof.

The Supreme Court also referred to its earlier jurisprudence, in particular its judgment dated 22 April 2016 (cases 2C_701/2015 and 2C_702/2015) concerning a company that had initially held a 23.55% equity interest in another corporation, of which it hat sold a portion of 1.25% in 2012 at a gain. In that case the Supreme Court had ruled that the participation deduction for capital gains requires cumulatively a minimum holding period of one year, a minim participation quota of 10% and a minimum sale quota of 10%. As regards the minimum sale quota, the literal language of the law was binding the Supreme Court. The participation deduction constituted an exception to the general rules of taxability of profits, which had to be construed in a narrow fashion. The special situation addressed by the second part of art. 70, para. 4, letter b DFTA did not change this. That rule was meant to clarify that, if a partial sale involving a qualifying investment quota of at least 10%, which was held for at least one full year, results in a remainder investment quota of less than 10%, sales of that remainder occurring in subsequent tax years remain eligible for the participation deduction, provided that the remainder as of the last day of the tax year preceding such a further sale has a market value of at least CHF 1 million. In the case at hand, the cantonal instances had relied on that prior jurisprudence of the Federal Supreme Court.

The Supreme Court supported the approach adopted by the prior courts. Based on the literal text of the law and the legislative history, a privileged partial sale of an equity quota of less than 10% can only occur, where the company has previously sold a qualifying equity interest of at least 10% that was held during at least one full year, and where the quota remaining after such first qualifying sale has a market value of at least CHF 1 million as at the end of any tax year preceding further sales of the remainder of the investment. Nonetheless, in an *obiter dictum* the Supreme Court pointed to some problematic consequences of this interpretation under the aspect of legal equality. The

Court pointed to two economically comparable situations with different tax consequences:

a) A corporate taxpayer initially owns an equity investment of 15%. During the tax year "n", it sells a quota of 10%, and in tax year "n+1", it sells the remainder. Both sales generate a principally eligible gain. As of the end of year "n", the value of the remaining investment is at least CHF 1 million. Participation deduction applies to the gains realized upon both fractional sales.
b) The taxpayer initially owns 15%, of which it sells 9% in year "n" and the remaining 6% in year "n+1". No participation deduction applies at all, even though the economic similarity to the situation a) is apparent.

However, according to the Supreme Court, such problems are inherent where the law operates with percentage thresholds. Moreover, the law is clear inasmuch as it requires the overall sale of a participation quota of at least 10%. If during the tax period "n" a quota of under 10% is sold, it remains uncertain whether the entire quota eventually being sold (including the first portion) will ever reach the threshold of 10% in future tax years. If so, this would call for a revision of the original tax assessment in the tax year "n". That solution would be rather impractical, and the tax legislator has not provided for any such revision.

Comments

We have little to add to the Supreme Court's comments. The Supreme Court did not need to address the question whether the required first qualifying sale of an investment quota of at least 10% in tax year "n" must occur in one single transaction, or whether it could also be comprised of several, potentially unrelated transactions with different buyers, each of which would pertain to equity quotas of under 10%. We see nothing in the law that would exclude such a scenario from the application of the participation deduction.