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Participation tax rules

The corporate tax systems of most European countries contain rules that provide some form of tax relief on income from participations. Under these rules, income, gains or losses from participations are often fully or partly disregarded. Switzerland also recognises participation relief in corporate taxation, yet its rules stand in sharp contrast to the ones commonly encountered, as they treat participations *a priori* as ordinary taxable assets. This provides both opportunities and pitfalls which taxpayers should be aware of.

The Swiss participation relief

Swiss tax law treats income or gains earned by a corporation from its participations as ordinary taxable business income, while losses from participations are fully deductible. Unlike other tax systems, Swiss tax law does not allow for an adjustment of taxable income for such items. Instead, the Swiss participation relief provides a rebate of the tax payable. The rebate is calculated by reference to the ratio between the net income or gain from qualifying participations and the total taxable income earned within a tax year.

For reference, a qualifying participation is, in respect to dividends, a participation of at least 10% of the share capital of another company, or of a fair market value of at least CHF1 million ($1 million). In respect to capital gains, it is a participation of at least 10% of the share capital of another company which has been held for a period of at least 12 months.

The decision of the Swiss legislator to treat, in principle, qualifying participations as fully taxable assets has a number of consequences that are often overlooked by investors, but which can turn out to be beneficial if properly planned for.

Importance of timing of dividends

The first consequence of the above principle is that income resulting from participations may potentially wipe out tax losses of the dividend-receiving company. This can be illustrated with the following example: a Swiss company suffering an operating loss of 100 receives in the same tax year a dividend of 100 from its subsidiary. Since the operating loss is compensated by the dividend income, the company's annual taxable income results in being zero. As a consequence, no participation relief (tax rebate) may apply for that tax year and, in addition, no tax loss can be carried forward. If, in the following year, the company earns an operating income of 100, that income is fully subject to tax since the prior year operating loss was compensated by the dividend income. Over the span of two years, the company thus pays tax over an income of 100, despite the fact that its operating result was zero during that period. In other words, the poor timing of the dividend distribution by its subsidiary prevented the application of the participation relief.

This simple example is sufficient to illustrate that, under the Swiss participation relief, timing of dividends should be set so that they are not paid into a Swiss company with existing or prior year tax losses. This often means that where a company has control over the dividend distributions of its subsidiaries, it is advisable to wait towards year-end before any dividends are distributed, to have more clarity about potential losses in the dividend-receiving company. If there is a need to access the retained earnings of the subsidiary in the meantime, other forms of cash movements such as an upstream loan may be considered.

Indirect use of subsidiaries' losses

The second aspect we would like to highlight is the mismatch in the treatment of gains and losses made in relation to participations. While gains can benefit from the participation relief and are not taxed (bar the situation described above), losses from disposals or write-downs of participations are tax deductible.

Against this backdrop, holding subsidiaries through a Swiss operating company may provide tax opportunities, in particular where new, risky or uncertain projects are carried out by the subsidiary. This may lead to an attractive tax outcome both in the case of success or failure of the activities conducted by the subsidiary.

In a nutshell, if the subsidiary's activities are successful, the Swiss company may enjoy dividends, or sell the subsidiary and realise a capital gain. In both situations, thanks to the participation relief, the Swiss company's tax liability in relation to the income is *de facto* removed. If, conversely, the subsidiary's activities turn out to be a failure, the Swiss company may write down the book value of the participation or sell the participation at a loss, thereby creating a tax loss which can be offset against operating income. This way, the subsidiary's loss can generally be used in the subsidiary's jurisdiction as well as (indirectly) in Switzerland. From a tax angle, it may therefore be advantageous to hold participations through a Swiss operating company.

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