



Tax Newsletter Switzerland

Private Capital Gains Redefined for MBOs and LBOs

Entrepreneurs in Switzerland thinking of selling their businesses they have built up over a lifetime may relax again. So may the Swiss MBO and LBO scene do. After a rather heated two year debate, the Swiss Parliament has finally fixed up a mess that was created by the Swiss Supreme Court in a much controversial decision rendered in June 2004.

Until then, both the federal and cantonal tax authorities had a somewhat consistent practise in their assessment of capital gains realized when one or more private shareholders sold out to a business investor. Such capital gains were considered private and therefore income tax free under two cumulative tests: (i) the purchaser did not receive during a five year post acquisition period any dividends or constructive dividends out of the target's free reserves existing as of the acquisition; and (ii) purchaser and seller did not collaborate in making such dividends or constructive dividends. As long as dividends and constructive dividends were made out of profits earned post acquisition, leverage and management buyouts could be structured without resulting in a taxable capital gain for private sellers. The Swiss Supreme Court in its June 2004 decision ended this favourable tax treatment, thereby raising much insecurity for the Swiss MBO/LBO scene over the last two years.

On June 23, 2006, the Swiss Parliament has now enacted various amendments to the Federal Income Tax Act of December 14, 1990, applicable retroactively to non-final tax returns covering profits earned in the tax years 2001 and later and still subject to a possible referendum. Any income taxation should now be limited, as a first test, to MBOs/LBOs where dividend and constructive dividends are made out of non-operating free reserves existing as of the acquisition. As a second test, the seller's passive collaboration would be given if he or she knew or should have known that the

dividends or constructive dividends were used in order to finance all or part of the purchase price for the target in a MBO or LBO. One should note that the tax authorities and tax courts usually presumed this second test in the past and will, most probably, continue to do so.

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