Taxation of the distressed company: finding the proper balance

OBERSON, Xavier
XAVIER OBERSON

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I. Introduction

Defining a proper taxation system for distressed companies is a delicate task. Indeed, in this context, the State, as a creditor of taxes due by the company, is a specific stakeholder, and a particularly powerful one. In this context, it is necessary to find a proper balance, not only between the interest of a special creditor and the investor, but also an equilibrium between the position of the State, as a special creditor, and the other private investors.

In addition, while it is important to secure the claim of the State, which represents public interest, an equitable solution must be found in order to mitigate bankruptcies and insure survival possibilities of enterprises in difficult financial situations. This implies that the tax consequences of the various possibilities to restructure a distressed company (cancellation of debt, assets sale, new money, re-evaluation, etc.) should be logical, fair and clear.

In this short paper, we will look at the Swiss system of taxation of a distressed company, both from the perspective of the State as a creditor and from that of the company as a debtor of taxes, to see to what extent the system would need re-examination.

II. The Position of the State as a Creditor

1. The Enforcement of Tax Claims

In Switzerland, the State is usually regarded as an ordinary creditor. In particular, the enforcement of tax claims is treated like an ordinary debt collection, which is ruled by the Federal Law on Debt Collection and Bankruptcy (LDCB). In other words, the State in principle is not in a privileged position for the enforcement of its tax claim. There are however a few particular rules which depart from this general principle.

First, for tax claims, the debt collection procedure may only be enforced by the seizure of assets of the creditors (Art. 43 LDCB). A debtor cannot be declared bankrupt simply because of tax claims, even if such debtor is subject to bankruptcy proceedings because it is entered in the Register of Commerce. However, if another private creditor has already initiated a bankruptcy proceeding against an enterprise, the State may participate in such a proceeding for the enforcement of its tax claims.
Second, the State still has a legal privilege attached to the recognition of its tax claims. Indeed, under the general rules, the debtor subject to a proceeding for enforcement of money claims usually has to declare “opposition” to the debt within 10 days after notification of the claim. The creditor then has to initiate a court action in order to remove the formal opposition. This can be done either (i) by obtaining an enforceable judgment, or (ii) by presenting in court an acknowledgement of debt from the creditor. The State, here, is in a better position since a formal enforceable decision of taxation is as a rule deemed a court judgment, subject to enforcement. It follows that both federal income and profit tax decisions, entered into force, ordering the payment of a tax claim, are generally assimilated to court orders, subject to execution. The same is true for cantonal tax claims, to the extent that cantonal law provides for such an effect. This is the case in most cantons.

2. Security for Tax Claims

As a matter of policy, while it appears that the State – subject to specific peculiarities mentioned above – is not in a highly privileged position as far as the enforcement of tax claims is concerned, the situation is quite different when considering the possibilities offered to secure in advance any potential or future tax claims. Here, the State is in a rather privileged position.

In particular, when there are signs that the debtor takes measures which could jeopardize the enforcement of the tax claims, the competent tax authority may demand security. The definition of “measures” subject to such security has been interpreted very broadly and case law is abundant. This is especially true if the debtor tries to leave the State. In the case of the federal withholding tax (“anticipatory tax”), the possibility of demanding security already exists as soon as the objective conditions of a tax evasion are met.

When the conditions are met, the Tax Authorities may obtain various types of security. The most frequent is an attachment of financial assets ordered by a court. In practice, the Tax Authorities also frequently ask for bank guaranties. At the federal level, both the competent authorities of the federal withholding

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1 See Art. 88 DTCB.
2 See, for instance, Art. 165 para. 3 of the Federal Direct Tax Law (DTL).
tax ("anticipatory tax") and the value added tax make constant use of these possibilities. Another possibility – more and more frequently used – is for the Tax Authorities to assert the tax unpaid by companies, in case of liquidations (including "factual liquidation"), against the so-called liquidators of the company. The term liquidator is rather broad and includes, notably, the directors in charge of the liquidation. Case law is very strict in this area, and the liquidators may only avoid the liability if they prove to have done "everything possible to insure payment of the tax due".

Thus, the position of the State seems to be well protected, notably by the possibility – recently increased – to demand security from companies in distressed situations or on the way to such situations.

3. Comments

In a nutshell, the policy adopted so far is not to grant important privileges for the enforcement as such of tax claims, but to offer many possibilities to secure a future enforcement at an early stage by granting extended security facilities. In particular, the application of strict security rules by both the withholding tax and the value added tax authorities is understandable. Indeed, in both cases, the enterprises subject to taxes are, in a way, collectors of a tax on behalf of the State. This is especially true for the VAT. After all, at least in the ideal model, this tax should only be borne by the final consumers. But this is also true for the withholding tax which, under Art. 14 of the Federal Withholding Tax Law, has to be transferred to the beneficiary of the payment subject to tax.

Finally, the fact that the debt collection procedure may only be enforced by the seizure of assets of the creditors and not according to bankruptcy may be questioned. It was apparently justified by the fact that the State has an interest to be paid quickly. In this respect, the seizure procedure is faster than bankruptcy. On top of that, it was argued that tax claims are usually of small

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4 See, in particular, Art. 15 of the Federal Withholding Tax Law (WTL), 55 DTL, 32 of the Federal Value-Added Tax Law (VATL).
5 See in particular, PETER LOCHER, Kommentar DBG, n. 1 ff. ad Art. 55 DTL; THOMAS MÜLLER, Die solidarische Mithaftung im Bundessteuerrecht, Bern 1999, p. 142 ff.
6 DOMINIQUE RIGOT, Le recouvrement forcé des créances de droit public selon le droit de la poursuite pour dettes et la faillite, Yens s./Morges 1991, p. 108.
amounts. One may however wonder if these considerations remain valid today.

III. The Position of the Enterprise

1. Taxation of Financial Restructuring of Companies in Distress

In case of insolvency, the entrepreneur will try to take various financial measures in order to secure or at least improve the position of the enterprise. The difficulty of the situation is often compounded by the fact that the tax treatment of those measures is rather controversial and often inconsistent, which leads to sometimes unfair and unjustified results. Allow me give you just two current examples.

Typically, a company in distress will be looking for new money (funds, cancellation of debts, for instance). In this context, a classic problem is to distinguish between measures which trigger a taxable profit for the company, and those which are regarded as a non-taxable increase of capital ("appor"). In our view, the test is twofold. First, the main criterion is the link between the person making the contribution and the benefiting company. As a rule, if a shareholder brings new funds, chances are that this should be treated as a non-taxable addition to capital. But this objective characterization is not sufficient because a shareholder may still enter into contractual relationship with the company in an arm's length capacity. Thus, the objective criteria should be followed by a more subjective analysis which checks whether or not the shareholder effectively acts in such capacity; in other words, it should be ascertained whether a third party, in a similar situation, would not have adopted the measure.

Unfortunately, the current situation does not seem to be as straightforward. The criteria are quite disputed among scholars and the courts have adopted a rather restrictive view. In particular, there seems to be a difference of approach in case of new money being brought into a company by a shareholder.

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and a cancellation of debts made by the same shareholder. In our view, the objective and subjective tests described above should apply for all measures. There does not seem to be an economic difference between new money and the cancellation of debts made by shareholders acting in such capacity.

But more importantly, the analysis applicable for direct tax purposes is not in accordance with the solutions adopted by other tax systems. In particular, a cancellation of debt, which meets the criteria to be characterized as a real streamlining for direct tax purposes, could still be subject to a 1% stamp duty because the conditions set forth under this regime are not necessarily the same as under direct tax law. Practices also differ for the authorities competent for the value added tax. The FTA, in a guideline dated July 2003, has adopted a definition different from the one applied for direct tax purposes, leading to conflicting results.

The tax consequences of profits triggered by measures helping the company represent another highly controversial – and quite technical – issue. In particular, to what extent should past losses be compensated by the new “profits” generated by new money? Another related issue is the possibility to use amortizations or provisions, incurred by the measures, for further profits generated by the company. In principle, the rule should be quite simple: measures which trigger a taxable profit will be compensated by past losses, amortizations and provisions. By contrast, measures which are not regarded as taxable profits should, in principle, not have an impact on losses, amortizations or provisions. In practice, this interpretation is just an exaggerated simplification of the situation, because there are many exceptions, and due to the fact that practice is becoming more restrictive. In particular, since 1995, the date of the entry into force of the new DTL, the Federal Tax Administration tends to consider that – even if measures do not trigger taxable profits – amortizations and provisions constituted by those measures are realized for tax purposes. It should, in our view, be recognized that this interpretation is in accordance with the principle that the commercial accounting rules are also relevant for tax purposes, absent a specific derogating tax provision.

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8 See in particular, ATF 115 Ib 269 (cancellation of debts) and especially Locher, op. cit., n. 25 ad Art. 60 with an analysis of all the different opinions suggested by this case.
9 FTA, Notice n. 23.
2. "Exit Strategies"

Finally, another essential aspect is to concentrate, not only on new financial means for the company, but to develop strategies to depart from distressed situations. These strategies may take various forms, such as mergers, spin-offs, or "management buy-outs". Here, from the point of view of the enterprise, trying to develop an exit strategy could be a vital means of insuring the survival of the company. However, from a tax standpoint, those types of strategies could have disastrous tax consequences. Indeed, the Administration, followed by the Supreme Court in particular, has developed extended interpretation of tax concepts, such as "hidden profits distributions", or "partial liquidation theory", which could have surprising consequences also in the case of streamlining.

It is well known that, so far, Switzerland has a classical corporation tax system with no alleviation of double economic taxation. However, capital gains by individuals on private movable assets are not taxable. This combination of rules has led, on the one hand, taxpayers to try to transform current dividend distributions into future capital gains and, on the other hand, the Administration – and the Courts – to develop a very broad definition of taxable profit distributions. This broad interpretation of taxable transactions could also have surprising consequences, for companies trying to get out of a distressed situation. I will just concentrate on two examples: (i) a case of merger of a rich into a poor company and (ii) a case of transfer of enterprise.

First, in a case of August 15, 2000, the Supreme Court took the view that a merger of a company in a positive financial situation into another company with a loss, triggered a hidden profit distribution corresponding to the amount of the loss, which was offset in the merger.\(^\text{11}\) Indeed, according to the Court, without a merger, the shareholders would have needed to bring new money to the distressed company. The reason for the merger is therefore only justified by the common shareholding between the two companies and results in a loss of tax substance.\(^\text{12}\) It is true that, if the purpose of such a merger is to recoup losses that would be lost absent such merger, the Tax Administration could very well consider that the loss compensation is a hidden profit distribution. This would typically be the case if one of the companies were in fact

\(^{11}\) Archives de droit fiscal suisse 70 (2001/02), p. 289 ff.
\(^{12}\) Archives de droit fiscal suisse 70 (2001/02), p. 292, voir Locher, op. cit., n. 32 ad 61.
economically liquidated. But the considerations of the Supreme Court seem to be quite general and tend to apply to most mergers cases between related “poor” and “rich” companies. However, it is probable that this approach is already no longer valid since the enactment of the new Merger Law, on July 1, 2004. In particular, the law has introduced a new legal institution called “fusion assainissement”. A merger of a company in a distressed situation with a company having sufficient open reserve is now possible, under the conditions set forth in Art. 6 of the Merger Law. Hopefully, this new development will alleviate the current practices of the Tax Administration – followed by the Court – which tend to treat such merger as a hidden dividend distribution.

Second, a recent case dated June 11, 2004, also raises new concerns. This case, which essentially covers the transfer of an enterprise within a family (so-called “Holding of heirs”), is not concerned with a company in a distressed financial situation. However, the reasoning of the Court is so broad that it could have a major impact on transactions like management buyouts.

In this case, Mr. X., sole shareholder of X SA, intended to transfer his company to his three children. For that purpose, he sold the company to X Holding SA, which had been incorporated by his children shortly before the transaction. The purchase price of the shares (CHF 5 million) was partly paid in cash (CHF 700,000) and the rest covered by a loan from Mr. X of CHF 4.3 million. An interest of CHF 400,000 minimum per year was due on the loan, which also had to be amortized. The Supreme Court viewed this transaction as a “partial indirect liquidation”. In a nutshell, the seller, instead of realizing a tax-free capital gain, was treated as having entered into a deemed liquidation of his company. As a consequence, the difference between the selling price (CHF 5 million) and the nominal value of X SA (CHF 100,000) was treated as a taxable dividend liquidation.

This case has been criticized because the Court did not seem to consider as relevant the fact that the purchase price was in fact financed not on current liquid earnings of the transferred company but on future profits. So far, however, a prerequisite for an indirect partial liquidation is an impoverishment...
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of the company sold on its liquid assets. This condition is not met here and this case appears to be another extension of an already problematic theory. Thus, such conclusion could then also apply in a typical management buyout, in which the managers have to finance the purchase price through important debts, which are by essence covered by future expected profits of the company.

3. Comments

In my view, the current situation is quite unsatisfactory, notably because of a lack of legal certainty in an area essential for distressed companies needing to act quickly. In addition, more fundamentally, case law has gone far beyond the "possible meaning" of the current legal provisions.

It is to be hoped that the legislative authority will react and adopt a clear legal framework for the taxation of distressed companies and streamlining strategies, which does not jeopardize any possibilities of recovery by an excessive tax burden. In this respect, the new Merger Law, of July 1, 2004, which has clearly improved the situation by shaping a legal framework favoring, as a rule, merger and acquisition of companies both from a commercial and tax standpoint, could serve as a model. The Merger Law tries to develop a harmonized and coordinated approach on specific transactions. The same should also apply for the taxation of distressed companies and financial restructuring measures. Unfortunately, the proper balance has yet to be redefined in this area.