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Limits to capital gains exemption – partial indirect liquidation

Introduction

After presenting the classification of an exempt capital gain as income from self-employment in the previous edition, we will now discuss another exception: the classification as income under the indirect partial liquidation rules.

The issue

The question of indirect partial liquidation arises when a taxpayer holds a stake in a profitable company that gives him a degree of control. As a shareholder, he has the choice between distributing the profits to himself and thus receiving taxable dividends (with partial taxation, if applicable), or accumulating them in the company in the hope of selling it at a better price. Since, in principle, the capital gain realised on the sale of shares held as private assets is tax-exempt, it is tempting to use this second solution to avoid taxation. However, this difference in treatment did not suit the federal legislator, who thus codified the conditions under which such a capital gain must be reclassified as a taxable return on assets for the seller.

Conditions

In 2007, the new article 20a para. 1 let. a and para. 2 LIFD came into force, listing the conditions for such a reclassification to take place.

1. Firstly, there must be a sale of shares. Gifts and transfers by inheritance are not concerned.
2. The sale must relate to a qualifying holding representing at least 20% of the company's capital, bearing in mind that this threshold may be reached by several persons selling jointly, including by sales staggered over time and carried out within a period of 5 years.
3. The sale must result in a change of taxation system, in that the shareholdings are transferred from the seller's private assets to the commercial assets of the buyer, who may be a natural or legal person domiciled in Switzerland or abroad.
4. A distribution of substance that is not necessary for the operation of the business and is distributable within the meaning of commercial law must be made. What constitutes substance not necessary to operations depends on the company's sector of activity. The reserves available for distribution are determined based on the most recently closed accounts approved by the General Meeting of the

target company at the time of the sale. The notion of distribution must be understood in the broadest sense. It includes concealed distributions of profits and other advantages in cash or in kind in favour of the acquirer or its shareholders.

5. The distribution must be made within five years of the sale.
6. Finally, it must be made with the participation of the seller. This condition implies that the seller knew or ought to have known that substance would be withdrawn to finance the acquisition. He must therefore show proper concern as to how the purchaser is going to finance the purchase price.

If all these conditions are met, the capital gain resulting from the sale is reclassified as a return on assets for the seller, in the amount of the distribution made. This may seem surprising given that the distribution is made to the buyer. To avoid negative consequences arising from an indirect partial liquidation, it is possible to request a ruling on the planned transaction and, in particular, on the determination of the substance not necessary for operations. In practice, however, it is more common for the buyer to contractually guarantee the seller that it will not make distributions that could be classified as an indirect partial liquidation within 5 years of the sale.

Conclusion

Indirect partial liquidation is a peculiarity of the Swiss tax system that is counterintuitive, since the taxable return is charged to the seller even though the distribution is received by the buyer. As the seller has no possibility of controlling what the buyer does once the stake has been sold, it is essential to include a clause protecting the seller in the sales contract.

Please do not hesitate to contact us if you have any questions.

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