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The hidden reserves

Status change from privileged to ordinary taxation for status companies

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Introduction

- With the adoption of the Federal Act on Tax Reform and AHV Financing (TRAF) on 19 May 2019, it was decided to abolish the special tax status (i.e. holding, domicile & mixed companies).
- ***Question***: **What happens to hidden reserves when switching from privileged to ordinary taxation?**
- The following open points need to be clarified:
  - What happens to the hidden reserves, including goodwill, which were generated under the privileged status?
  - Do hidden reserves have to be disclosed in the tax balance sheet?
  - Is it better to switch from privileged to ordinary taxation before or after the entry into force of TRAF?

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Previous legal situation & practice

- The tax authorities allow the disclosure of hidden reserves (step-up) under certain conditions upon change of status
- The full or partial disclosure of hidden reserves including original goodwill is permitted
  - No real realisation, merely for tax purposes
  - The disclosure is tax-neutral
- Only certain reserves can be disclosed
  - Hidden reserves on investments and properties cannot be disclosed
- After disclosure, the disclosed hidden reserves are generally written off against ordinary profit within five or ten years (depending on the canton)

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Previous legal position & practice

- Taxable profit decreases as a result of annual depreciation
- The resulting tax effect depends on the amount of the hidden reserves and profit development
- The step-up method approach is permitted until the entry into force of the TRAF bill on 1 January 2020
- Cantonal practice regarding step-up is inconsistent
- The procedure must be discussed with the tax authorities

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Valuation of an enterprise

Valuation of an enterprise

- In order to determine the amount of hidden reserves including original goodwill, the company is valued.
- The value of the enterprise is determined using the “Praktikermethode“ *(2 x Earnings value + Asset value : 3),* possibly also other methods are allowed, such as the DCF-method
- The earnings value is based on the company's profits of the last three years and is multiplied by the capitalisation rate.
- Net asset value corresponds to the equity of the company at the time of valuation

$$\frac{2 \times \text{Earnings value} + \text{Asset value}}{3} = \text{Enterprise value}$$

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Valuation of an enterprise

Determination of hidden reserves including original goodwill

- After calculating the hidden reserves for the whole enterprise, the value that can be assigned to the special status must be separated.
- Only the amount of hidden reserves which were generated under the special status can be depreciated without affecting tax

Valuation of an enterprise / calculation example

Determination of hidden reserves including original goodwill

Earning value	Total	Foreign source income	Domestic income	Earning value:
Profit 2018	40'000'000	40'000'000	0	
Profit 2019	43'000'000	43'000'000	0	
Profit 2020	46'000'000	46'000'000	0	
Average over 3 Years	43'000'000	43'000'000	0	
Taxation quote of the foreign source income 25 %		-10'750'000	10'750'000	
Average profit	43'000'000	32'250'000	10'750'000	
In percent	100	75	25	
Discount factor 7.5 %				**573'333'333**

Earning value	Total	Foreign source income	Domestic income	Enterprise value
Earning value				573'333'333
Double quantifier				573'333'333
Asset value				
Available net equity	100'000'000			
Hidden reserve	8'500'000			
				108'500'000
Enterprise value				**418'388'889**

Valuation of an enterprise / calculation example

Determination of hidden reserves including original goodwill

Calculation hidden reserves	-	Enterprise value
Enterprise value		418'388'889
Available net equity		100'000'000
During the mix company hidden rerserve		318'388'889

Seperate hidden reserves	-	--	Total
Landed Property	2'500'000		
Other Reserves	5'000'000		
Investment	1'000'000		
More assets	0		
Total			8'500'000
Orginary goodwill			309'888'889

Cantonal tax & village tax	Taxable special rate	Ordninary taxable	Total
Hidden reserve (= average 2018-2020) in %	75	25	
Landed Property		2'500'000	2'500'000
Other Reserves	3'750'000	1'250'000	5'000'000
Investment	750'000	250'000	1'000'000
Goowill	232'416'667	77'472'222	309'888'889
More assets	0	0	0
Total	236'916'667	81'472'222	318'388'889

Special rate solution

Which will be introduced or come into force within the framework of the TRAF bill on 1 January 2020

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Special rate solution

- It will be compulsory to change status upon entry into force of the TRAF bill
- The change in status applies to privileged companies only, i.e. holding, domicile and management companies
- At the time of the status change →***Valuation of hidden reserves including original goodwill (slide 9 ff.)***
- The STAF bill provides for a special rate solution for hidden reserves that have been formed tax-free in the past by these companies

Special rate solution

- The valuation of the hidden reserves will be approved by means of an official notice of determination from the tax authorities
- The hidden reserves calculated including goodwill will be used with a special rate in a special account for a period of five years
- During the special accounting phase, the company concerned will usually disclose an overall tax burden that corresponds to the previous special status
- There is no disclosure of hidden reserves in the commercial and tax balance sheet
- The remaining, unused hidden reserves expire after this five-year period and is subject to ordinary taxation

Special rate solution

- Hidden reserves will be separated into foreign source income and domestic income according to silde 9 ff.
- The foreign source share varies depending on the company and the legislation of the respective canton
- During the five-year special tax rate period, the net profit will also be separated into foreign source income and domestic income
- The profit of the company which is allocated abroad is subject to the privileged taxation with the special rate calculation
- The profit allocated to the domestic market is subject to ordinary taxation
- Additionally, the federal tax needs to be considered
- This procedure takes place over a period of 5 years

Special rate solution

- The hidden reserves are not disclosed in the tax balance sheet, which means that, unlike the step-up method, this does not lead to an increased capital tax
- The determination of the amount of the special rate is the responsibility of the cantons, whereby the current trend lies between 0% and 3%
- The TRAF bill comes into force on 1 January 2020 and the cantons are obliged to adapt their cantonal legislation by that date
- From the entry into force of the new regulation, the step-up method will no longer be possible, and the special rate solution will be applied.
- Note: in any case, the relief limitation of maximum 70 % must be taken into account!

Comparison of both methods

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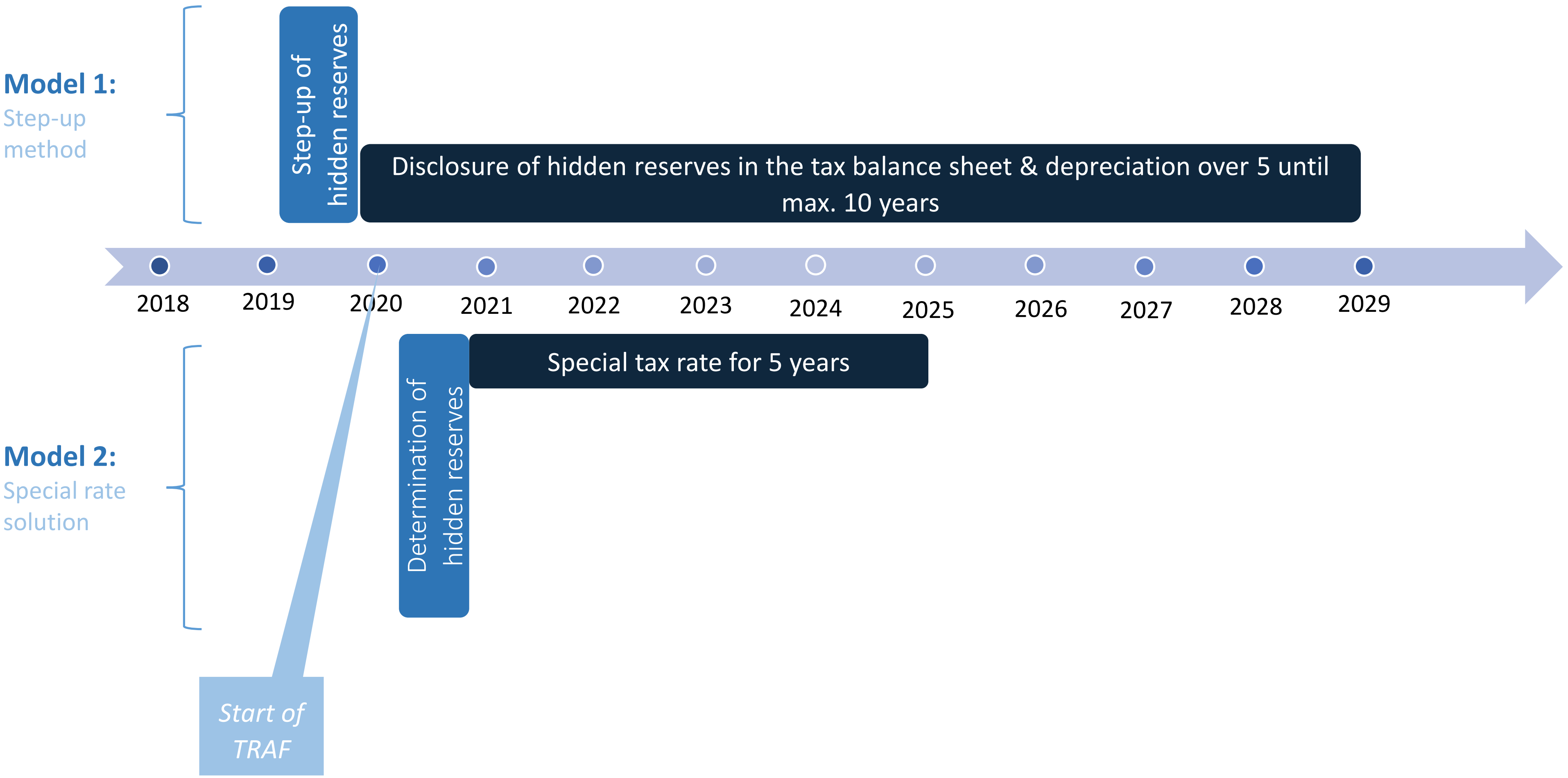
Comparison: previous vs. future model



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Comparison: previous vs. future model

- Step-up method
  - A means of disclosing hidden reserves including original goodwill
  - The disclosure in the tax balance sheet leads to an increase in the assessment basis for capital tax purposes
  - Can be depreciated over 10 years in annual profit
- Special tax rate method
  - A means of determining hidden reserves including original goodwill
  - Also referred to as shadow accounting because no new capital is disclosed as a result of the realisation, and consequently, there will be no capital tax
  - Hidden reserves are taxed at a privileged rate for five years only

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Summary

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Summary

- There are two methods for the treatment of hidden reserves created during the special tax status, the step-up method and the special rate solution
- The **step-up method** is no longer possible after the TRAF has come into force. There are few precedents regarding a status change with the step-up method
- At first glance, the **special rate solution** seems more lucrative, but it only applies for five years, which means that compared to the step-up method (if 10 years can be depreciated), a further four years may have to be added, which are subject to ordinary taxation and one year (2019) in which they can still claim special status
- It is recommended to carry out an exact examination as soon as possible, taking into account as many factors as possible, in order to make a sound decision on a change of status before or after the entry into force of the TRAF bill

Summary

- If there is a status change before the STAF enters into force on 1 January 2020, the special status will be dissolved immediately ex nunc
- It has to be clarified with the respective cantonal tax administration how the calculation methods, special rates, depreciation rate & duration, etc. are to be designed
- According to the current situation and our provisional calculation methods, a change of status before the entry into force of the TRAF bill could be more lucrative, depending on the canton. This provided that a step-up is permitted at all and under the reservation of accounting effects

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Deferred taxes under IFRS

- Under the step-up method, the hidden reserves are disclosed in the tax balance sheet but not in the IFRS balance sheet
- Disclosure in the tax balance sheet results in a tax-deductible temporary difference
- Disclosure on the tax balance sheet increases the tax base at the time of the status change, but this is not actually taxed / is taxed at a 0% rate
- In accordance with IAS 12.24, a deferred tax asset must be recognised in the IFRS balance sheet to the extent of the applicable tax rate on this step-up amount
- This capitalisation leads to a one-time tax benefit in the year of the status change. This one-time effect can result in certain disadvantages for companies