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by Werner Lederer and Thierry Boitelle

Before the entry into force in 2007 of Switzerland's new Federal Act on Collective Investment Schemes (CISA), which introduced the Swiss limited partnership for collective investments (Swiss-LP),[1] Switzerland never had an officially published practice on the treatment of distributed carried interest in the hands of fund managers for Swiss income tax purposes because the Swiss-LP was simply not foreseen under Swiss law.

Of course, the issue already existed before the introduction of the CISA — for example, in an international context where a Swiss resident person acts as a manager of a foreign limited partnership (LP) — but the need for a consistent and harmonized approach had not been identified as yet. Instead, the cantons were more or less free to rule on matters on a case-by-case basis.

With the introduction of the new CISA, the domestic situation has changed and the Swiss Federal Tax Administration (FTA) is expected to issue two circulars that will deal in a general way with the taxation of collective investment schemes and their investors, both for Swiss federal income tax purposes and for Swiss withholding tax and stamp duty purposes. It is not yet clear exactly when the circulars will be published (other than in the first half of this year). However, because the treatment of carried interest for income tax purposes is of major importance, the FTA soon will issue a special circular letter instructing the cantonal tax authorities, which are also competent to levy federal income tax, how the carried interest can be treated for Swiss federal income tax purposes. The letter will not deal with the taxation of the carried interest in a comprehensive manner, but will only inform the cantons what the FTA is willing to accept for Swiss federal income taxes.

In developing those guidelines, the FTA has consistently taken the view that the whole carried interest will be subject to income tax because the whole carried interest is effectively connected with the manager's activity for the fund. If that view prevails, the tax-free capital gain realized (for example, on a sale of shares) by any shareholder who plays an active role in a company in which he owns an interest will be jeopardized. That fact, along with the fact that Switzerland wants to become more attractive for fund managers, might be why, according to unconfirmed reports, the cantons and various interest groups have put pressure on the FTA to rethink that position. Full taxation of the carried interest clearly would not fit into the Swiss income tax system when private capital gains remain untaxed. (The same is true for full nontaxation.)

Therefore, the new guidelines will present a good overview of how Switzerland will treat the question of carry-taxation based on existing law, and also imply that to achieve certainty in a concrete structure it is advisable to take up discussions with the competent authority in due time.

The new carried-interest circulars will, in principle, deal only with Swiss federal taxes. However, because the Cantonal Income Tax Acts are largely harmonized with the Federal Income Tax Act, it must be assumed that the federal circular letters will also have an important impact on the treatment of carried interest for cantonal income tax purposes.

Treatment of the Swiss-LP

For income tax purposes, the Swiss-LP is treated as a transparent contractual investment scheme. It becomes a Swiss taxpayer only if it directly invests in Swiss real estate. Because of the tax transparency, any item of income is taxable in the hands of the partners instead of the Swiss-LP.

[1]The Swiss-LP resembles a U.S. limited partnership. It is designed for investments in risk capital and is therefore used primarily for private equity and hedge fund investments. This article focuses on private equity funds but applies equally to hedge fund structures.

The limited partners pay taxes on distributions based on their personal status and place of residence. Only qualified investors can be limited partners in a Swiss-LP. Qualified investors include institutional investors, such as banks, insurance companies, and pension funds, as well as high-net-worth individuals. Capital gains realized by individuals generally are exempt from Swiss income tax if the investment is held as a private asset.

The general partner, which must be a stock company (an AG or SA under Swiss law) with registered offices in Switzerland, is subject to ordinary taxation in Switzerland on the income derived from the Swiss-LP (as described in more detail below).

The subscription of an interest in a Swiss-LP is exempt from Swiss issuance stamp tax, and Swiss-LPs are exempt from Swiss transfer stamp tax on the trading of taxable securities. However, the trading of shares in a Swiss-LP by a Swiss investor who qualifies as a securities dealer is subject to transfer stamp tax because shares in a Swiss-LP are considered to be taxable securities.

Distributions made by a Swiss-LP are, as a matter of principle, subject to Swiss dividend withholding tax at the domestic rate of 35 percent. The law, however, provides for an important exception: Capital gains distributed to the investors are not subject to withholding tax if paid out separately (with a separate coupon). Because private-equity LP structures tend to focus on the realization of capital gains, this exemption is of major importance.

From a VAT perspective, it must be noted that turnover with shares is exempt under Swiss VAT law (with no right to claim back the input VAT).

Taxation of Carried Interest

Carried interest typically results if the private equity investments are sold by the LP with a substantial gain. After having distributed the preferential gain (hurdle) to the limited partners in accordance with the rules set out in the limited partnership agreement, part of the gain realized (often between 10 percent and 20 percent of the overall gain) is distributed to the fund managers. This carried interest thus remunerates the successful commitment of the managers to the fund. If the fund managers also invest their own funds in the LP structure, the carried interest at least partially also constitutes a capital gain realized on the investments sold. The identification of the different elements of carried interest is crucial within the Swiss income tax system, because capital gains realized by individuals are exempt from income taxation if the asset sold can be recognized as a privately held asset.

The investment by the managers of their own means can be structured in two different ways: Either they make investments into the LP via the management company controlled by the managers, or they can invest directly in the LP. For Swiss tax purposes, the question of how the investment is structured makes a difference in how the carried interest will be treated (although from an economic point of view, the effect is the same under both alternatives and for all parties involved).

In an international context — in which typically the management company and the managers on the one hand, and the LP (and the general partner) on the other hand, are not resident in the same country — the investment must be carefully examined to determine whether there is a possibility under internationally accepted profit allocation methods to exclude part of the carried interest or other income items from income/profit taxation in Switzerland.

Investment by Managers Via the Management Company (Swiss Stock Company)

The ordinary rules for the taxation of income in the hands of the Swiss stock company generating the carried interest are applicable. Carried interest distributed to the company (together with the other income of the company, such as management fees) usually is subject to tax at the ordinary profit tax rates. The requirements for the participation deduction on the capital gain element realized on the sale of the investment (participation) normally will not be met because the participation typically is lower than 20 percent. Although that threshold recently was lowered to 10 percent (although that change is not yet in force and still must pass a referendum at the end of February), that normally still will not allow for relief under the Swiss participation deduction rules because the private equity participation of each of the managers and the management company typically will not even reach the 10 percent threshold. Also, the FTA in a 1998 circular (regarding the participation relief) generally denied the participation character of investments in a collective investment scheme.

For cantonal profit tax purposes, it must also be determined whether the Swiss resident company qualifies for a privileged cantonal taxation regime (such as for an auxiliary, mixed, or domiciliary company).

If ordinarily taxed, the overall effective tax burden of the company typically ranges from 15 percent to 25 percent, depending on the canton where its seat and offices in Switzerland are located. Under a privileged cantonal tax regime, the effective rates would be as low as 9 percent to 12 percent, depending mainly on the canton.

Upon distribution/payment of the gain to the managers, depending on the personal status and place of residence of the managers, additional income taxation will occur in their hands (economic double taxation).

A Swiss resident manager will have to pay income tax at the ordinary rates on the municipal, cantonal, and federal levels. The overall tax burden depends on where (in which canton and in which municipality) the manager is resident. If the payment made by the general partner constitutes salary, social insurance contributions of approximately 13.1 percent (consisting of both the employer's and the employee's part) also become due. If the payment to the manager is made in the form of a dividend, that results in a higher profit tax burden at the level of the company because the dividend is not deductible. Depending on where the manager resides, however, he may benefit from a preferred dividend income taxation regime. In many cantons, the overall tax burden on dividend income can be reduced by 40 percent to 50 percent if a shareholder holds at least 5 percent or 10 percent, respectively, of the shares of a Swiss company. Another benefit may be that no social security charges become due if the profit is paid out in the form of a dividend.

For managers residing outside of Switzerland, the ordinary taxation rules prevailing in an international context apply. If the carried interest is passed on from the Swiss company to the foreign resident manager in the form of a dividend, Swiss withholding tax at a rate of 35 percent becomes due, although that rate may be reduced under the provisions of an income tax treaty.

Direct Investment by Managers

Under this alternative, the managers directly invest their own funds into the LP. In other words, the managers become an additional class of (managing) limited partners in the LP. The managers receive only a salary (or a fee similar to a salary) from the management company. The carried interest is distributed directly to the managers on liquidation of the fund according to the rules set out in the partnership agreement.

According to Swiss income tax law, all sorts of income are subject to income taxation. There are some exceptions to this rule (for example, gifts that are subject to a separate tax), the most important being the exemption for capital gains realized by an individual on the sale of a privately held asset.

For Swiss income tax purposes, it is therefore crucial to determine whether the carried interest at the level of the managers constitutes a capital gain. If it cannot be considered a capital gain, it must be regarded as other income subject to income tax. If the carried interest is regarded as a capital gain, it must be determined whether the investment made by the manager constitutes a privately held asset or a business asset. A gain realized on the sale of a privately held asset is fully exempt from income tax. A gain realized on the sale of a business asset, on the other hand, will be fully subject to Swiss income tax and social security charges.

The carried interest as a participation by the managers in the profit realized by a collective investment scheme on its liquidation compensates the profitable management of the investment fund by the managers, as well as the increase in value of the investment made by the managers themselves. The carried interest therefore combines both. Part of it is a capital gain realized on the ''own'' investment made by the managers, and the other part is a participation of the managers in the capital gain of the other ''ordinary'' limited partners. In the hands of the managers, this latter part of the carried interest does not represent a capital gain attributable to their own investment in the structure, but will instead be regarded as ordinary (taxable) income.

As mentioned above, a mere capital gain remains exempt from income tax. In determining this part of the carried interest, the prevailing principle is that the managers have the same right to realize a tax-exempt capital gain as any other Swiss resident limited partner (not acting at the same time as a manager of the fund). In simple terms, the (tax-exempt) capital gain of a manager will be determined by (theoretically) calculating his gain as if he had made an investment ''only'' as an ''ordinary'' limited partner. That part of the carried interest will, as per the Swiss income tax system, remain exempt. The remainder of the carried interest cannot be deemed a capital gain relating to the manager's investment and is therefore subject to ordinary income taxation.

If the carried interest does constitute ''other income,'' the social security charges of 9.1 percent should at least be avoidable, but for now, that is still a matter of controversy. Considering that social security charges paid on income items above the threshold of approximately CHF 84,000 per year do not generate additional old-age annuities, the social security contributions become an additional tax burden and must therefore be added when the overall tax burden is determined. Because of the progressive nature of the tax rates in Switzerland, that can easily result in charges on the taxable part of the carried interest of between 20 percent (for example, in Zug or Schwyz) and 40 percent (for example, in Zurich, Lausanne, or Geneva). The final tax burden obviously depends on how the carried interest is ultimately composed.

Because the carried interest typically is realized only at exit and accrues over the years of the investment, one could argue that the progressive nature of the applicable tax rate can be broken by dividing the carried interest by the number of years the investment has lasted in determining the applicable tax rate. Swiss tax law provides for such antiprogression exceptions in special cases. If the competent tax authority allows the taxpayer to apply such provisions for the taxation of the carried interest, this can lead to significantly lower income taxation.

In an international context (that is, where only some of the managers are resident in Switzerland and the LP is registered abroad), it should be determined whether, in accordance with recognized international profit split methods, the income subject to tax in Switzerland can be reduced. However, based on practical experience so far, it cannot be expected that this would dramatically improve the situation, particularly not in an offshore context, which is often the case with private equity and hedge funds.

Conclusion

Although the treatment described above does not yet reflect the final Swiss answer to the question of carried-interest taxation, it is not expected that substantial modifications will be made that would make the system more favorable for Swiss resident managers, and the system outlined herein will, in the end, most likely be the prevailing one in Switzerland.

An important downside of the Swiss approach is that Swiss resident managers are not in a position to pre-estimate the tax burden they will ultimately face on receipt of the carried interest. This will certainly not help to attract fund managers to Switzerland. It can only be said that the lower the carried interest is, the lower the income tax burden will be (possibly even nil). But this is of little comfort to the manager.

The general income tax rates in Switzerland are of a progressive nature. Swiss tax law does contain an exceptional provision stating that one-time payments compensating recurring payments can be taxed at a rate as if the income would not have been paid out at once, but in each relevant year. For the purpose of carried-interest taxation, this would mean that the taxable part of the carried interest remains unchanged. For the determination of the applicable tax rate, however, the carried interest under this exceptional approach would be divided by the number of years the investment has lasted. Because of the progressive nature of the rates, this could lower the tax burden significantly. It has to be assumed that the Swiss tax authorities will take an open-minded approach toward such optimization possibilities, especially as their clear aim was — and still is, within the framework of what Swiss tax law allows — to be competitive with regard to carried-interest taxation. On the one hand, there is reason to be confident that a competitive form of taxation can be reached in Switzerland, but on the other hand, it is doubtful that Switzerland can actually offer more favorable solutions than those prevailing in competing jurisdictions and financial centers.

It is understood that the taxable part of the carried interest represents other income under Swiss income tax principles and therefore may not be subject to old insurance charges. If that is not correct and this additional charge cannot be avoided, Switzerland will most likely not be competitive in an international context.

It appears that no Swiss-LPs have been registered in Switzerland so far. Besides the problem of the 35 percent Swiss withholding tax on regular income (as opposed to the exemption for distributions of capital gains), the main reason for that is likely the treatment of the carried interest for income tax purposes in Switzerland. ◆

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