Cross-border real estate structures: How to exit?

Stephan Pfenninger and Stephanie Eichenberger of Tax Partner – Taxand look at Swiss cross-border real estate structures in the context of Swiss special purpose vehicles (SPVs) holding foreign real estate or Swiss properties held by foreign SPVs and identify the best methods for exiting such structures.

Most real estate structures are historically grown. At the time they were implemented, the structures seemed advantageous, for legal, tax or other reasons. After a period of time, it may turn out that a real estate holding structure is not only costly to maintain but comes with various other adverse issues. This may be due to a change in the legal environment, the tightening of certain tax rules or simply a change of ownership.

In today's world, a cross-border real estate structure should be focused on the location of the real estate, that is, the entity holding the real estate should be domiciled in the same jurisdiction as the real estate. The logic behind this is fairly simple: the less jurisdictions involved, the lower the administrative cost and overall risk.

Switzerland is involved in cross-border real estate structures both inbound and outbound. There are a number of foreign real estate investors who invest into Swiss commercial real estate. In addition, Swiss investors would go for foreign real estate.

Swiss properties are normally held through a Swiss real estate company (SPV). However, some investors, for practical, legal, tax or other reasons acquired their Swiss properties via a foreign SPV, for example in Luxembourg. The same applies to foreign properties: there are a number of Swiss companies owning foreign real estate, for example in France or Germany. These cross-border structures are often costly and without any tax benefit, or may even be disadvantageous from a tax point of view. Therefore, investors seek for simplification and would like to transform the real estate holding structure to a pure Swiss or foreign set-up in order to make the current holding of the property more efficient or to avoid any obstacles for a future sale of the property in a share deal. Potential buyers certainly prefer a legal set-up where the holding company is situated in the same country as the real estate.

The critical question is whether a structure can be adjusted to a pure local set-up without triggering taxation of the inbuilt surplus value on the real estate. Since the tax amounts involved are usually substantial and the funds for paying the tax on the surplus value not available due to the lack of realisation and cash-in of the surplus value, a careful exploration of legal and fiscal possibilities and restrictions in all concerned jurisdictions is needed.

Foreign company holding Swiss real estate

The first and most obvious scenario would be to move the Swiss real estate from the foreign SPV to a Swiss SPV. However, in Switzerland (as in most other countries), such transfer leads to a taxable capital gain, and to real estate transfer tax. A sale or a transfer of the real estate as dividend in kind or in the course of a liquidation of the foreign SPV will always result in a change of legal ownership of the property, relevant for real estate capital gains and transfer taxes, even if the ultimate beneficial owner of the real estate remains unchanged. The legal transfer of ownership normally triggers the following taxes in Switzerland:

- Real estate transfer tax of 1.0% to 3.3% on the transaction price, depending on the location of the real estate.
- Corporate income tax of 11.2% to 24.2%, depending on the location of the real estate. In most cantons, the difference between the fiscal book value and the fair market value is subject to corporate income tax. In some cantons, the difference between the book value and the fair market value is subject to corporate income tax at federal level only (at the rate of 7.8%). At cantonal level, recaptured deprecation (difference between book value and investment value) is subject to corporate income tax, whereas on the surplus value on the property separate real estate capital gains tax will be levied.
- Real estate capital gains tax of 4% to 73.6%, depending on the location of the real estate and the duration of the ownership (discounts for long holding periods and speculation surcharges for short holding periods). Real estate capital gains tax is levied by some cantons on the surplus value (difference between initial cost/investment value and fair market value).

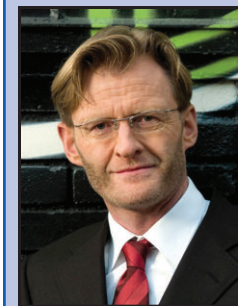
As an alternative to the transfer of the Swiss real estate to a Swiss SPV, the foreign SPV could be moved "across the border" to Switzerland. Switzerland and several other countries allow the transfer of the statutory seat to a different jurisdiction without liquidating the company. Such transfer of the statutory seat to Switzerland would not constitute a change of ownership of the property and would therefore not trigger real estate transfer tax or capital gains tax. Also for corporate income tax there is no issue. No Swiss stamp duty would be levied on the equity of the new Swiss SPV either, unless the action could be viewed as abusive. In the foreign jurisdiction the transfer of seat will typically not trigger any capital gains tax since the Swiss real estate has been allocated to Switzerland. However, the transfer of seat may be seen as a deemed liquidation of the SPV and therefore trigger foreign withholding tax.

The foreign SPV owning the Swiss real estate could also be moved to Switzerland via a cross-border merger. Switzerland legally allows such cross-border mergers provided such a merger is allowed in the other country as well (reciprocity). A merger is considered a tax neutral transaction for Swiss tax purposes. Therefore, if the foreign SPV will be absorbed by a Swiss SPV, no adverse Swiss tax consequences will be triggered. The transaction will be viewed as a tax neutral restructuring for Swiss tax purposes.

Because of the high legal cost typically associated with a genuine cross-border merger, such transactions are rare. However, in practice, the transfer of all assets and liabilities including the Swiss real estate of the foreign SPV to a Swiss company (parent company of foreign SPV), followed by the formal liquidation of the foreign SPV into the Swiss company, has been viewed as a deemed merger by the Swiss tax authorities. Such deemed merger has been accepted as a tax neutral reorganisation without triggering any real estate transfer tax and capital gains taxes if the transfer of assets and liabilities was made at fiscal book values. The maintenance of the Swiss fiscal book values is an issue since it will not always be accepted in the country of the legal domicile of the foreign SPV in the context of the liquidation of the latter. Further, in the deemed merger scenario, the shares in the foreign SPV will often need to be transferred to the Swiss SPV acquiring the assets of the foreign SPV. This transfer of shares may also be subject to Swiss real estate capital gains and transfer taxes unless a respective ruling for a tax neutral transfer will be obtained. In addition, the foreign tax consequences of the liquidation of the foreign SPV need to be checked carefully.

A further alternative to the move of a foreign real estate company "across the border" is the transfer of management

Biography



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Stephan Pfenninger, attorney at law, has more than 20 years experience of local and international tax. Stephan started his career as a corporate lawyer in Zurich. Later he moved to a Big 4 company working in financial and tax law. Since 1998 Stephan has been a partner of Tax Partner AG.

Besides national and international corporate tax law, Stephan's activities are mainly focused on real estate tax mandates. He is a tax adviser for listed and non-listed Swiss and foreign institutional real estate investors (including investment companies, pension funds, insurance companies, banks) as well as for individual investors in the area of tax efficient structuring of real estate transactions, current tax optimisation of real estate portfolios and the creation of tax efficient real estate investment products, and so on. He is a speaker and lecturer at significant tax seminars, and has published various articles on international and national real estate tax.

Tax Partner is one of the leading tax firms in Switzerland. With 32 professionals, the firm advises multinational and national corporate clients as well as individuals. Tax Partner co-founded Taxand in 2005 – a global network with more than 2,000 tax advisers and 400 partners from independent member firms in 50 countries.

Biography

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Stephanie Eichenberger is a certified Swiss tax expert, master of law and attorney. She started her career with the tax chamber of the Zurich administrative court in 2000. From 2004 to 2007 she worked for the law firm of Lenz & Staehelin in Zurich. She started working for Tax Partner AG in 2007.

Stephanie, whose native language is German and who is also fluent in English and French, has a wide-ranging field of activity from advising private clients to Swiss and multinational corporate clients. Stephanie also specialises in tax litigation and the taxation of Swiss real estate.

and control to the jurisdiction of the property country. If management and control of a real estate company with statutory seat outside of Switzerland is transferred to Switzerland, this creates a fiscal presence in Switzerland. The foreign SPV will become subject to unlimited Swiss income taxation. Once the effective place of management and control of the real estate holding company is in Switzerland, all income and assets of the real estate company will be subject to Swiss corporate income tax. Since the assets of the SPV mainly consist of Swiss real estate which was also subject to Swiss income tax before the move of management and control, the transaction has no negative income tax effects. With regard to the Swiss real estate held by the foreign SPV, no change occurs and therefore no capital gains tax or real estate transfer tax will be triggered.

The tax consequences of the move of management and control in the country where the statutory seat of the foreign SPV still is depend on local law as well as on the existence of a tax treaty and its content. If there is no tax treaty preventing taxation, the foreign real estate company usually remains subject to taxation in the jurisdiction where the statutory seat is located. In most jurisdictions, the income tax effect linked thereto on the Swiss real estate assets is not material since the taxation right with respect to the Swiss property is allocated to Switzerland. More relevant in this regard is the dividend withholding tax: dividends of the foreign SPV having its fiscal domicile in Switzerland will now trigger Swiss dividend withholding tax (at a rate of 35%, under reservation of tax reduction under treaty). Depending on the shareholders of the SPV, the fact that Swiss withholding tax newly applies on dividends may lead to a tax benefit for the investors due to protection under a respective tax treaty. Or, if the shareholder of the foreign SPV is a Swiss resident, he could now fully reclaim withholding tax on dividends. This may be the main reason for moving management and control of the foreign SPV to Switzerland.

However, dividend withholding tax is normally tied to the statutory seat of the SPV under national law. Hence, after the transfer of management and control, dividends distributed by the foreign SPV may be subject to both foreign and Swiss withholding taxes. Still, all tax treaties following the OECD model tax convention provide for an exclusive right to levy dividend withholding tax by the state where management and control of a company is located. Exceptions to this rule are foreseen in the Swiss tax treaties with, for example, Germany and Japan where the statutory seat keeps full withholding taxation rights irrespective of which country the company is managed and controlled in.

Due to such potential tax and legal problems, the transfer of the effective place of management of the foreign SPV to Switzerland is not the preferred option if there is a viable alternative. In addition, the legal seat of the SPV will still be abroad which is not in line with the needs of the investor and the main reason for the restructuring of the Swiss real estate set-up. However, in certain specific cases it may be the best (and/or only) solution at hand.

Swiss company holding foreign real estate

If a Swiss company holds foreign real estate, it may again be an option to transfer the foreign property to an SPV located in the property country. As mentioned above, most jurisdictions will impose capital gains taxes and transfer taxes on such transfer of the foreign real estate.

For taxes in Switzerland, the transfer of the statutory seat of the Swiss SPV to the jurisdiction of the country where the property is located will be treated as a deemed liquidation of the SPV. This means that dividend withholding tax of 35% on the equity and hidden reserves exceeding the share capital and the capital contribution reserve (from shareholder contributions) of the Swiss SPV becomes due upon moving the company to the property country. This tax issue is very important since substantial tax amounts are involved. It needs to be assured that the foreign shareholder of the Swiss SPV is tax resident in a country with a tax treaty providing for a low withholding tax rate. Ideally, a 0% Swiss withholding tax on the liquidation dividend will apply and withholding tax will be reduced to 0% at source. Even if, under the treaty, Swiss withholding tax is 0%, for cash management reasons it should be avoided that withholding tax needs to be remitted to the Swiss federal tax administration and subsequently, needs to be reclaimed by the shareholder.

A cross-border merger of a Swiss real estate company with a foreign SPV is possible for Swiss legal purposes. However, for Swiss tax purposes the cross-border merger will again be treated as a deemed liquidation of the SPV since the real estate company leaves Switzerland and prevents Switzerland from levying tax on future income and dividend distributions. Switzerland would not levy capital gains tax on the foreign assets transferred. However, again Swiss withholding tax would apply on the deemed liquidation dividend. In addition, the foreign tax consequences of the merger will need to be checked carefully with respect to capital gains and transfer taxes.

As an alternative to a cross-border merger and the transfer of the legal seat, only management and control of the Swiss SPV could be transferred abroad. This may improve the overall tax situation of the foreign real estate set-up since after such move the Swiss SPV may be integrated in the foreign fiscal group of the investor.

The tax consequences of the transfer of management and control of the Swiss SPV to a foreign country depend on the existence of a tax treaty and its specific content. As to the foreign real estate nothing changes for income tax purposes since the latter was subject to foreign taxation and exempt from Swiss taxation also before the transfer of management and control. With regard to movable assets held by the Swiss SPV, there may be Swiss income tax on hidden reserves, though these would not normally be significant.

Under a tax treaty that contains the OECD tie-breaker rule in favour of the place of effective management, the transfer of the place of management and control of the real estate holding company out of Switzerland will result in an exit with regard to dividend withholding tax as well. Correspondingly, a 35% withholding tax will be levied on the equity including hidden reserves of the Swiss SPV exceeding the share capital and the capital contribution reserve, unless a 0% withholding tax applies under a respective treaty (see above). If management and control of the SPV is transferred from Switzerland to a non-treaty state, the SPV will remain subject to Swiss dividend withholding tax and, therefore, no exit tax is triggered. However, should the collection of the possible withholding tax liability be at risk, which would be the case if nothing but the statutory seat remained in Switzerland, Switzerland can enforce the possible exit tax on a provisional basis and ask for corresponding collateral.

A situation similar to the transfer of management and control to a non-treaty state exists between Germany and Switzerland. The tax treaty contains a tie-breaker rule in favour of the place of effective management but states as well that dividend withholding tax may be levied by the country where the statutory seat is located, regardless of the place of effective management. Should a Swiss SPV owning German real estate move its effective place of management to Germany, Switzerland could still levy withholding tax on future dividends. This specific clause in the treaty facilitates the relocation of Swiss real estate entities across the border to Germany as no dividend withholding tax should be triggered by the transfer of the place of management and control. However, in view of this rather unusual structure and the potential double taxation, negotiations with the German and Swiss tax authorities are recommended in advance of the execution of such a transfer.

VAT

With regard to the cross-border real estate structures described in this article, VAT should also be taken into account. Depending on the type of real estate – commercial or residential – being held, the real estate company typically is registered as a VAT taxpayer both in the countries where the statutory seat and the real estate are located. Before the statutory seat or the place of management and control is transferred to a different jurisdiction, the VAT status of the real estate holding company needs to be determined as well as if the intended transaction requires additional VAT registrations.

The way to go

In our experience, most cross-border real estate structures can be simplified if needed and there are a variety of legal and fiscal possibilities for resolving the issues and improving the overall set-up of the real estate investment. Normally, there are ways to tax efficiently structure the reorganisation. The issues involved are critical though. Each case has to be analysed carefully to avoid the combined pitfalls of real estate taxation and international double taxation. In some instances, the result of the analysis may still be that the most beneficial and cost efficient scenario is to maintain the structure that is already in place even if it might not be the perfect solution for the structure, be it today or in the future.