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Swiss Tax Practice Regarding Thin Capitalization ("hidden equity")

Legal Situation in Switzerland

Legal entities in Switzerland are generally subject to federal, cantonal and communal income tax and a capital tax both on cantonal and communal level. Interest on debt is principally income tax deductible at the level of the paying entities to the extent the interest is considered at arm's length.

In order to protect the Swiss tax base (i.e. to set a maximum threshold for each company's debt-financing and corresponding tax-deductible interest), the Swiss Federal Tax Administration (SFTA) issued special thin capitalization rules in 1997, which are intended to restrict the maximum debt amount that is allowed from related parties. Related party debt exceeding the permitted debt amount is qualified as hidden equity and is added back to the taxable capital. The total amount of maximum allowed debt depends on the underlying asset categories and is calculated for each balance sheet position as a percentage of its fair market value (c.f. the following table):

Cash and cash equivalents	100%
Accounts receivable	85%
Other receivables	85%
Inventories	85%
Other current assets	85%
Domestic and foreign bonds in CHF	90%
Foreign bonds in foreign currency	80%
Domestic and foreign listed shares	60%
Other shares	50%
Participations	70%
Loan receivables	85%
Property / equipment	50%
Factory premises / plants	70%
Home property, construction land	70%
Other real estate	80%
Cost of constitution, capital increase and organization	0%
Intangibles, incl. goodwill	70%

The total of these amounts so calculated equals the maximum allowed debt of the company.

For financing companies, the calculation method is slightly different: These companies may generally have non-equity positions of 6/7 of their gross assets at fair market values.

Hidden Equity

If a Swiss company has debt in excess of the total amount of allowed debt (calculated as mentioned above), it shall be deemed to be thinly capitalized – unless the company can prove that the actual debt has been provided by independent third parties and that neither the shareholder(s) nor any other person that is close to the shareholder(s) have guaranteed the debt (loan) or a third party test for higher debt can be evidenced.

Tax Consequences

- The allowed maximum interest deduction on debt for a company is determined by multiplying the

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allowed debt (calculated as mentioned above) with the safe harbor interest rates for related party loans published yearly by the SFTA in a circular letter. Interest that exceed the calculated maximum amount will be added back to the taxable profit and will be subject to corporate income tax.

- Furthermore, such excess interest (i.e. interest expenses on debt re-qualified as hidden equity) is generally regarded as a hidden dividend distribution which is subject to Swiss withholding tax at a rate of 35%. Withholding tax levied may be fully refundable for Swiss tax resident recipients based on domestic law and in certain cases may be notified if timely and duly declared. For foreign tax residents, a full or partial refund may only be claimed based on a respective double tax treaty or the Swiss-EU savings agreement.
- Hidden equity is generally subject to annual cantonal and communal capital tax of the Swiss company.

Conclusion

In order to avoid a thin capitalization issue and the outlined adverse tax consequences, it is recommended that Swiss resident companies regularly monitor their maximum debt capacity or ensure that appropriate documentation of the arm's length character of the exceeding debt could be provided.

Please note that this briefing contains only a generic overview and does not purport to be comprehensive, nor a detailed advice for any specific case that might arise.

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