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The jewel of Europe

Dan Barabas
Commercial editor
International Tax Review

Switzerland is a peculiar European country. Nestled hundreds of metres into the Alps, it has the GDP and population of an eastern European economy, but houses roughly 30% of the Fortune 500 in some capacity.

In the world of fund management, it may not see the level of currency regional neighbours like Luxembourg may see circulate through its borders on behalf of institutional investors, but to individuals, family offices and private bankers the world over, it has served as a virtual money pit thanks to a long history of banking secrecy laws.

But what makes Switzerland such a desirable place for business? One can argue that historically, it has always had a competitive tax rate, but today, that is a race being lost in Europe as the likes of American giants such as BlackRock and Facebook flock to cities like Budapest and Dublin to set up European operations, where corporate tax rates can hit as low as 9% and 12.5%, respectively.

Globally, that margin is slipping even further as the US largely halves its corporate tax rate to 21%, while the UK's (still Europe) 19% seems negligible to Switzerland's 18%.

It is no surprise then that corporate tax reform has remained a big issue in Switzerland in recent years, with 2019 no exception as tax reform goes to a second referendum in May.

To answer many of your queries, *International Tax Review* has partnered with several Swiss tax advisors to give you the key tax takeaways for the year ahead on everything from information exchanges, to tax incentives and audits.

We hope you find the 2019 guide useful.

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Withholding tax changes for Swiss debt issuance

Withholding taxes are commonly applied in Switzerland to certain debt issues, even though many foreign jurisdictions have abolished such taxes. **Bär & Karrer**'s Christoph Suter and Susanne Schreiber discuss how Swiss issuers are increasingly limiting their tax exposure through foreign subsidaries and observing lender limits.

Within the realm of international bond markets, investors generally do not accept a deduction in withholding taxes (WHTs) on interest. Bond issuers in jurisdictions where a WHT applies may therefore suffer a competitive disadvantage, as they may either have to increase interest rates in order to guarantee an attractive yield (net of WHT), or face limited demand for their offering due to its reduced attractiveness. Both situations lead to an increase in the issuer's costs.

While many industrialised countries have abolished WHTs on bonds issued to international investors (ultimately maintaining the competitiveness of their domestic issuers), Switzerland still levies a 35% federal interest WHT on certain types of collective debt issues.

Withholding taxes in Switzerland

Unlike many other countries, no WHT is levied in Switzerland on interest paid on private and commercial bilateral loans. However, since the WHT definition of 'bond' and 'debenture' is broader than the definition used by Swiss civil law or in financial markets, certain bilateral loans (particularly if syndicated), may fall under the definition of a bond or debenture, triggering WHT.

Due to the WHT on interest, Swiss-based borrowers tend to raise debt capital through foreign subsidiaries that are established in jurisdictions where no WHT applies to such debt instruments. Generally, these issues need to be guaranteed by the Swiss parent companies in order to benefit from the parent's issuer credit rating.

While there are sound commercial reasons for foreign issues with a Swiss parental guarantee, the Swiss Federal Tax Administration (SFTA) has defined criteria under which it considers the use of a foreign issuer as abusive, and assimilates the debt instrument as a Swiss issue, potentially subject to WHT. A recent change of the SFTA's practice has brought a welcome relaxation of the conditions under which this assimilation takes place.

The definitions of bond, debenture and bank, as well as the conditions under which a bond is issued by a foreign issuer under a Swiss parental guarantee are critical in order to determine whether the raising of debt capital is subject to WHT.

Bond and debenture definitions

Swiss withholding tax practice defines bonds or debentures as written debt acknowledgments for fixed amounts that are issued in multiple

tranches for the purpose of collective financing, and which allow the investor to evidence, reclaim or transfer its receivable claim.

A bond is defined as the issue of written debt acknowledgments over a fixed amount to more than 10 non-bank lenders at identical conditions (in terms of interest rate, lending period, repayment conditions, etc.), provided that the total amount of issued debt amounts to at least CHF 500,000 ($496,000).

A debenture is defined as the issue of written debt acknowledgments over fixed amounts to more than 20 non-bank lenders at variable conditions, provided that the total amount of issued debt amounts to at least CHF 500,000.

As the above definitions suggest, Swiss and foreign banks (as defined by the Swiss Federal Banking Act or comparable foreign banking legislation at the place of establishment of the lender) are not counted as lenders, unless the debt acknowledgements are securitised (e.g. in the form of bearer bonds, so that the issuer would not know whether the bond is held by a bank or a non-bank).

Furthermore, following a legal amendment a few years ago, companies under common consolidation with the issuer are no longer counted as lenders under the aforementioned definitions. However, as bond issues are rarely subscribed by group companies of the issuer, this amendment is of minor relevance in the context of international bond issues.

Transfer restrictions

In order to avoid WHT applying to the borrower, Swiss issuers who raise debt capital from international investors therefore seek to observe the number of lenders specified under any debt issue. This is done by introducing contractual transfer restrictions in the credit agreements, which aim to restrict the transferability of the debt instruments.

The transfer restrictions can disallow any transfer, or transfers to non-bank lenders. It is also common to seek consent from the issuer for any transfer. The transfer can then be denied by the issuer if the number of lenders exceed 10 or 20.

Since lenders generally want to be able to transfer their receivables to third parties, such contractual transfer restrictions may make the offering less attractive to investors. Swiss issuers therefore regularly issue debt instruments through their foreign subsidiaries.

Bank interest and withholding taxes

In addition to interest on bonds and debentures, bank interest is also subject to WHT. Like for bonds and debentures, the WHT definition of a 'bank' is broader than the notion generally used in banking or financial markets. In addition to banks being subject to the Swiss Federal Banking Act, any Swiss resident person or company qualifies as a bank for WHT purposes (if it holds interest-bearing customer deposits from more than 100 depositors whereby the aggregate amount is at least CHF 5 million).

For bonds and debentures, Swiss and foreign banks (as defined by applicable banking legislation) and companies under common control with the issuer are not counted as lenders/depositors towards the 100 lenders.

The basket counting method

In practice, whether the allowed number of 10, 20 or 100 lenders is respected remains of utmost importance when assessing the WHT consequences of debt capital raising. According to the practice developed by the SFTA, the debt instruments can be divided into different categories (or 'baskets'), and counted separately (basket counting method). These are:

- Bonds;
- Short-term debentures (fixed term debt of no more than one year);
- Long-term debentures (fixed-term debt of more than one year);
- Debentures related to guarantee or security deposits such as cash-collaterals in securities lending or repo transactions; and
- Customer deposits related to current accounts (debt without any fixed time limit).

A debt instrument is only counted in one basket at a time. In particular, where a debt issue qualifies as a bond (because the number of lenders exceeds 10), the same issue is not counted in the short-term debentures (if the term of the issue is no more than one year) or long-term debentures basket (if the term of the issue exceeds 12 months).

If the number of permitted lenders is exceeded in one of the baskets, WTH is due only on interest paid on debt within that basket. There is no contamination of the debt instruments pertaining to the other baskets.

Foreign issuers and Swiss parental guarantee

Interest on bonds/debentures of non-Swiss issuers is generally not subject to WHT, regardless of the number of lenders under such debt instruments. However, under certain circumstances, bonds/debentures issued by a non-Swiss issuer may be likened to Swiss bonds/debentures for WHT purposes, and therefore WHT may have to be deducted on the interest payments.

Firstly, a foreign issuer may be a Swiss tax resident for WHT purposes if it is effectively managed in Switzerland and carries out business activity. Under domestic tax residency rules, such a foreign issuer would be considered a Swiss issuer and the bond/debenture would therefore be classed as a Swiss issue.

Secondly, the foreign issuer may be considered a special purpose vehicle (SPV) whose only purpose is the issue of a

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Susanne regularly supports Swiss multinationals in their tax planning work, including tax advice on restructurings, financing and tax litigation work.

Susanne is a German attorney-at-law and tax advisor, and a Swiss certified tax expert. Before joining Bär & Karrer she worked for an international law firm in Germany and for one of the Big 4 firms in Zurich where she last headed the Swiss M&A tax department.

bond/debenture on behalf of the Swiss parent. Under the general anti-avoidance rule in Swiss tax law, such an issue would be deemed to have been directly made by the Swiss parent company, thereby disregarding the foreign SPV.

In light of the above two scenarios, it is critical to ensure that a foreign subsidiary of a Swiss multinational issuing debt instruments has the necessary financial, physical and/or operational substance to ensure that the issue can be considered as a genuine non-Swiss issue. For example, this would be the case if the foreign issuer carried out a proper finance function at its place of establishment, taking care of activities such as capital raising, inter-company funding or liquidity management for the group.

Thirdly, under a long-standing SFTA practice, the issue of debt instruments by a foreign issuer may be subject to WHT even if the foreign issuer has the necessary substance, provided that the issue is made under a formal guarantee from a direct or indirect Swiss parent company and the proceeds of the issue directly or indirectly flow back to the Swiss parent company or another Swiss affiliate. In such a case, the SFTA deems the issuance to be economically similar to a direct issuance by the Swiss parent company, based on the general anti-avoidance rule.

As the parameters of this 'assimilation rule' are well established, it can be used as a safe-haven rule when structuring debt capital of Swiss-headquartered groups. If there is either no guarantee by a Swiss parent company, or no flow-back of the issue proceeds to Switzerland, the debt instrument of the foreign issuer is not subject to WHT.

As to the guarantee, the assimilation rule only applies when a (direct or indirect) Swiss parent company acts as a guarantor to its foreign subsidiary (downstream guarantee). Guarantees by Swiss subsidiaries or Swiss sister companies of the foreign issuer (upstream and cross-stream guarantees) are generally not considered harmful, as Swiss corporate law limits the validity of such guarantees to the guarantor's freely distributable reserves.

Direct and indirect flow-backs

As to the flow-back of the issue proceeds to Switzerland, this includes direct as well as indirect flow-backs. There is a direct flow-back to Switzerland if the foreign subsidiary, which

issued the bond, lends funds to a Swiss group entity that accounts for a corresponding liability on its balance sheet.

There is an indirect flow-back if the issuer lends the funds to a foreign group entity, which accounts for a corresponding liability on its balance sheet, or which in turn grants a loan to a Swiss group company. Accordingly, flow-backs through dividend distributions or capital contributions to a Swiss entity are generally not harmful. Depending on the individual case, this may also be the case for settlements of pre-existing liabilities towards Swiss group entities.

Notwithstanding, and according to a recent loosening of the SFTA's administrative practice as of February 5 2019, a flow-back of issue proceeds to Switzerland is permitted in an amount that corresponds with the sum of the combined accounting equity of all non-Swiss subsidiaries directly or indirectly controlled by the Swiss parent company (so-called equity alternative), plus the aggregate amount of loans granted by the Swiss parent and all its Swiss subsidiaries to its non-Swiss affiliates (compensation alternative).

Under these new limits for flow-backs of proceeds to Switzerland, many Swiss multinationals (in particular those with substantial equity in its foreign subsidiaries) can increase the volume of bond issues through their foreign subsidiaries under a parental guarantee, reducing their exposure to WHT. However, they need to closely monitor the limits for flow-backs to Switzerland as exceeding the limits would trigger WHT on the foreign debt issue.

Furthermore, the SFTA requests that the method for calculating and documenting the flow-back limits available under the equity alternative and the compensation alternative are agreed in an advance tax ruling. This method, once agreed with the SFTA, has to be maintained for continuity reasons.

In case of a bond issue by a non-Swiss subsidiary with a guarantee from the Swiss parent company, the borrower must undertake that the flow-back of proceeds from the bond issue to Swiss affiliates will not exceed the amount available under the equity alternative and the compensation alternative. If these flow-back limitations cannot be respected, the discussed transfer restrictions need to be introduced in the credit agreement to avoid unwanted WHT consequences.

Withholding tax outlook

These new rules give Swiss multinationals more leeway in how to use funds raised through bond issuances by their foreign subsidiaries, and undertakings in credit agreements may be relaxed going forward.

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