7. Developments in Cross Border Aspects of the Swiss Withholding Tax

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Introduction

In an international context, Switzerland is considered an attractive business location, not least due to the Swiss tax system. However, one aspect in which Switzerland compares unfavorably with its main competitors is its withholding tax regime and the high withholding tax rate of 35%.

This concerns, in first instance, the tax regime for bonds and notes and, in particular, the damping effect of the Swiss withholding tax on interest payments. Switzerland imposes a 35% withholding tax on interest payments on notes and bonds issued by Swiss borrowers. The withholding tax is also imposed on interest payments by foreign subsidiaries of Swiss companies, provided that the notes / bonds are guaranteed by a Swiss parent and the proceeds from the issuance are used in Switzerland, e.g. are directly or indirectly on-lent to Swiss group companies. The regime does not allow for a reduction / exemption of the 35% withholding tax at source. Swiss investors may normally either set off the withholding tax liability against their ordinary tax liability or request a refund. The position of international investors depends on the provisions of the applicable double tax treaty. The double tax treaty between Switzerland and the US provides for the full refund of the withholding tax on interest. However, the administrative procedure and costs for the refund process and a liquidity disadvantage make Swiss bonds less interesting even for investors entitled to a full refund of the withholding tax, not to mention foreign and institutional investors.

Swiss Guaranteed Bonds with Use of Proceeds under New Practice

In 2019, the Swiss Federal Tax Administration, based on the amended withholding tax ordinance, relaxed the rules in respect of the withholding tax on foreign bonds guaranteed by Swiss parent companies by introducing a safe harbor rule for on-lending into Switzerland. Under this rule, it is permissible to on-lend to Swiss group companies an amount up to (i) the sum of equity of foreign subsidiaries and / or (ii) outstanding debt of foreign subsidiaries towards the Swiss group companies. The practice helps Swiss headquartered groups to issue bonds through, for example, US finance entities and gain access to a broader investors base without triggering Swiss interest withholding tax, provided that the group can demonstrate (generally per year end) that it did not exceed the above thresholds. The equity test is rather generous since the foreign subsidiaries' equity amounts are not calculated on a consolidated but on an added basis. Further, this test can be combined with the loan test, that is, the maximum on-lending threshold is increased by the amount of outstanding debt of foreign group entities towards Swiss group entities. Since these amounts could be repaid and transferred back to Switzerland, a use of notes or bonds proceeds for on-lending into Switzerland up to this amount is also permitted.

Since its introduction, many Swiss groups have made use of the new practice. Whereas in the past, funds received by foreign issuers could generally only be used abroad, e.g. for foreign acquisitions, the Swiss group can now – up to the allowed threshold – repatriate the funds and use them for domestic transactions or even funding of dividends / share repurchases. However, debt issuance by Swiss vehicles is still generally subject to interest withholding tax. Thus, in a further, significantly more wide-reaching step, in April 2020 Swiss Federal Council proposed a conceptual reform of the withholding tax on debt instruments, the central element of which is the move from a debt-based system to a paying-agent system.

Paying-Agent Withholding Tax Regime

The move to a paying-agent withholding tax regime has been discussed already for some time by the Swiss legislators. The new proposal was published and submitted to the legislative consultation procedure by Swiss Federal Council on April 3, 2020.

The main concept of the reform is that the withholding tax will no longer be deducted and paid by the borrower making the interest payment and instead by the paying agent of the investor.

Based on the current proposal, the withholding tax must be deducted if (1) the objective and (2) subjective criteria are fulfilled and (3) the paying agent qualifies as taxable person.

Objective criteria

The reform will broaden the objective scope of the interest withholding tax. In addition to Swiss bonds, the withholding tax would apply to interest payment on all foreign bonds (irrespective of whether such foreign bonds are guaranteed by a Swiss parent or not), indirect interest payments (e.g. from investment funds) and income from structured products that replicate capital assets subject to Swiss withholding tax.

As far as indirect interest payments are concerned (e.g. in the form of income from structured products and investment funds), the reform proposal requests that the interest income subject to the withholding tax is separately identified. If the necessary identification data is not available, the full amount of income paid out will be subject to Swiss withholding tax. The same rules apply to accumulated profits in case of accumulation funds. In this case, the withholding tax must also be paid by a paying agent, even in the absence of the corresponding cash flow to the paying agent.

Subjective criteria

Only interest income of individuals based in Switzerland is subject to Swiss withholding tax. No withholding tax is due on payments to foreign based investors and Swiss-based corporate investors.

Taxable persons

Swiss withholding tax on interest payments is due and must be deducted only by Swiss-based paying agents. Swiss-based financial institutions holding notes in depository accounts, Swiss-based issuers (provided no financial institution holds the notes), Swiss-based portfolio managers and trustees and other Swiss-based payers may qualify as paying agents.

Importantly, only the last paying agent in the chain is under an obligation to deduct and deliver the withholding tax.

Interest payments via foreign paying agents will not be subject to Swiss withholding tax.

For Swiss-based issuers of notes and Swiss-based collective investment schemes, the change to a paying-agent based regime is voluntary. These parties can choose whether they will continue to apply the currently existing debtor-based regime or will switch to the paying-agent regime. For foreign issuers and foreign collective investment schemes the application of the paying-agent regime is mandatory.

The consultations procedure in respect of the reform proposal is open until July 2020. The parliamentary debates are not expected before 2021 and entry into force, if adopted, is not expected before 2022.

Implications for US borrowers

US borrowers distributing notes in Switzerland may need to consider the impact of the change to the paying-agent regime and withholding tax on interest payment on their eventual tax gross-up obligations. Considering the entitlement to full refund by Swiss individual investors in respect of such withholding tax, an appropriate solution would be the exclusion of the respective tax gross up.

"Three-Corner" Approach for Withholding Tax

Another problematic aspect of the Swiss withholding tax regime, the so-called direct beneficiary approach, often proves difficult in practice in case of non-arm's length intercompany transactions:

In principle, should a Swiss company provide goods or services to an affiliated company or receive them under non-arm's length conditions, Switzerland treats such non-arm's length transactions as a constructive dividend, subject to a 35% withholding tax on dividends.

The "three-corner" approach and "direct beneficiary" approach determine which party is considered to be the recipient of such a dividend and, as a result, is entitled to claim the refund of the 35% withholding tax on dividends and benefit from a double tax treaty.

The choice between two methods is relevant with respect to constructive dividends resulting from transfer pricing adjustments due to non-arm's length terms between related parties other than parent and subsidiary, for example, sister companies. With respect to income tax, Switzerland applies the "three-corner" approach: a deemed distribution to the direct parent company followed by a deemed contribution from the parent to the subsidiary. However, with respect to the withholding tax Switzerland applies in the same situations the "direct beneficiary" approach. The sister company is deemed to receive the constructive dividend directly from its sister, not via the joint parent.

In exclusively domestic configurations, where all involved companies are based in Switzerland, the application of the "three-corner" approach or the "direct beneficiary" approach do not lead to significantly different outcomes.

In an international set-up, the applicable method is, however, critical. As per the current practice, the affiliated sister company is deemed to have the refund right, which is assessed based on the applicable double tax treaty between Switzerland and the country of incorporation of the sister company. The constructive dividend is considered to constitute a "dividend" under the applicable double tax treaty. Since the sister company does not hold any shares in a Swiss company directly, the preferential parent-subsidiary regime is not triggered and the residual 15% withholding tax rate is applicable. Moreover, this approach also bars the application of the notification procedure (reduction at source) and requires the actual cash payment followed by the more burdensome refund procedure.

The approach has long been criticized. In December 2019, a motion requesting the application of the "three-corner" approach in all cases in respect of the withholding tax was filed with the Swiss Parliament.

If adopted, the reform would – based on a statement by the Swiss Federal Council – result in a significant decrease of the withholding tax exposure with respect to international transfer pricing. Under the "three-corner" approach the direct parent company would be deemed to receive the dividend. In the majority of cases, the international shareholding of Swiss companies is structured in a manner allowing to avoid withholding tax on dividend distributions by Swiss companies to their direct parent companies. Should the "three-corner" approach be adopted, these direct parent companies would also have the right to request (ordinarily) full refund of the withholding tax or avoid the withholding tax on such constructive dividends altogether by applying the notification procedure. With respect to US parent companies, the dividend withholding tax could be reduced from 15% to generally 5% in these situations, e.g. non-arm's length transactions between Swiss subsidiary with a US parent and a non-Swiss sister entity based anywhere in the world.

Unsurprisingly, the motion was welcomed in the business community. The Swiss Federal Council – due to the substantial decrease of tax income which would result from the reform – applied to reject the proposal. The motion is currently under review in the Parliament and is expected to be debated in 2020.

Overall Conclusion

The new practice on the use of proceeds with respect to foreign bonds introduced in 2019 is a move in the right direction and facilitated to a certain extent the external financing for Swiss headquartered groups. The long discussed abolition of the Swiss withholding tax on interest with respect to foreign or Swiss corporate lenders and change to a paying-agent system for Swiss individuals is still required to enable Swiss companies to directly issue notes through Swiss vehicles. The current proposal of April 2020 tries to find a viable solution, however certain points, e.g. liability of the paying agent, funding of withholding tax in case of accumulating funds, may still be under discussion. The motion to apply the "three-corner" approach also for withholding tax would result in a long awaited alignment with the income tax treatment and international practice. Technically rather undisputed, it remains to be seen if it will find the political support, in particular in these Covid-19 times as tax revenues are expected to become lower anyway.

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