Tax concerns for foreign investors

Thomas Graf, Daniela Schmucki-Fricker and Markus E Kronauer of Niederer Kraft & Frey outline the withholding tax and stamp duty issues that arise in debt financing transactions for Swiss companies by non-Swiss lenders

In general, the Swiss tax environment is considered advantageous for foreigners investing in Switzerland. But due consideration must be given to the issues of withholding tax on certain interest payments and stamp duties (securities issue tax and securities transfer tax).

Debt instruments are not subject to Swiss securities issue and transfer taxes or to Swiss withholding tax as long as they do not qualify as a collective fundraising scheme. Collective fundraising schemes such as bonds (*Anleihensobligationen*) and medium-term notes (*Kassenobligationen*) are subject to securities issue tax (bonds: 0.12% of the nominal value for each year of the maximum duration; medium-term notes: 0.06% of the nominal value for each year of the maximum duration) if a Swiss issuer issues them. A Swiss issuer is an issuer with legal domicile in Switzerland or an enterprise domiciled abroad and registered in a cantonal register of commerce in Switzerland, for example, as a branch. Furthermore, securities transfer tax is levied if a so-called registered securities dealer (*Effektenhändler*) is either a party or an intermediary to a sale of bonds or medium-term notes, whereby an increasing number of exceptions is available. Interest payments on bonds and medium-term notes are subject to Swiss withholding tax at a standard rate of 35%, which is substantially reduced if a treaty from Switzerland's broad double taxation treaty network applies. The Swiss withholding tax must be charged to the recipient of the interest payment. If the Swiss withholding tax is not withheld from the interest payment, the Swiss issuer will have to pay the Swiss withholding tax of 35%, based on the gross interest payment being deemed to be 65%. This results in a Swiss withholding tax burden of 53.8% of the gross interest payment. Any provision in the terms of the bonds or notes providing for a gross-up obligation of the issuer could be held, based on a respective legal provision, as void and not enforceable against the Swiss issuer. Should the non-Swiss lender be protected in case of unexpected Swiss withholding tax consequences, it is advisable to include a minimum interest rate provision separately from any tax clause or gross-up provision.

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Mortgage secured loans need special attention because the direct federal tax law as well as the Swiss cantonal tax laws provide for an income tax to be levied at source on interest payments on loans secured by Swiss real estate. The applicable tax rates vary from canton to canton and are limited by Swiss double taxation treaties to rates between 0% and 15%, depending on the treaty in question. In the canton of Zurich, the standard source tax rate is 17%.

Swiss tax practice requires arm's length financing of a Swiss company. The Circular Letter No 6 Regarding Hidden Equity issued by the Swiss Federal Tax Administration on June 6 1997 contains safe-haven rules including maximum debt-financing levels for particular categories of assets. If a financing structure is not at arm's length, Swiss income and withholding tax consequences (constructive dividend distribution) may arise. Furthermore, the hidden equity may be subject to capital tax.

Definition of bonds and medium-term notes under Swiss tax law

A loan facility is treated as a bond for Swiss withholding tax and stamp duty purposes if the loan is considered a collective fundraising scheme, pursuant to the Swiss Withholding Tax Law, the Swiss Stamp Duty Law and the practice of the Swiss Federal Tax Administration as published in the Guideline regarding Tax Treatment of Syndicated Loans, Non-bonded Loans, Notes and Sub-participations (published in January 2000). A collective fundraising scheme is assumed if the following conditions are all met:

- there are more than 10 non-bank lenders;
- the loan amount is at least SFr500,000 ($400,000); and
- the loan conditions are identical, referring to a single loan agreement only.

Pursuant to the Guideline regarding Bonds issued by the Swiss Federal Tax Administration in April 1999, a company creates medium-term notes for the purposes of the Swiss Withholding Tax Law and the Swiss Stamp Duty Law (the Laws) if the following conditions are all met:

- money is borrowed under varying conditions on a continuing basis;
- more than 20 non-bank lenders are involved; and
- the total loan amount is more than SFr500,000.

As a consequence, the conditions for a medium-term note for the purposes of the Laws are met if the number of non-bank lenders and of all private placements and single loans (including intra-group loans) from non-banks of a Swiss borrower exceeds 20.

Therefore, as a rule of thumb, if more than 10 non-bank lenders effectively participate or could participate – directly or indirectly – in a loan facility or if

the Swiss borrower is financed by more than 20 non-bank lenders, the Swiss tax consequences of a financing structure must be carefully investigated.

Any lender not qualifying as a bank within the meaning of the Laws counts as a non-bank lender. A foreign bank will be considered a bank if the laws of the jurisdiction of the office in which it accounts for the loans qualify it as a bank and if it carries on a genuine banking activity there. Finance companies, holding companies, investment companies and investment funds do not qualify as banks.

In order to avoid adverse Swiss withholding tax consequences, loan facilities with Swiss borrowers should provide for the following:

- if any (potential) lenders under the loan facility are not banks within the meaning of the Laws, the legal documentation should explicitly exclude that the 10 non-bank rule could be violated;
- transfers, assignments or sub-participations are allowed only if the transferee, assignee or sub-participant is again a bank within the meaning of the Laws;
- the Swiss borrower is obliged to represent that at any time the aggregate number of non-bank lenders that the borrower owes interest-bearing money to under all interest-bearing instruments of the borrower taken together (other than bond issues or medium-term notes issues which are subject to Swiss withholding tax) does not exceed 20.

To admit non-banks as lenders it is necessary to have detailed approval procedures in place to make sure that at any time the 10 non-banks rule and the 20 non-banks rule are complied with. As the Swiss borrower is liable for Swiss withholding tax and Swiss issue stamp duty towards the Swiss Federal Tax Administration, an involvement of such a borrower in these approval procedures is necessary.

Structures involving foreign vehicles

In general, Swiss tax authorities accept structures where foreign vehicles raise funds through a collective fundraising scheme and the funds raised are transferred to Switzerland through a single loan, as long as the foreign vehicle does not issue sub-participations in the single loan and as long as the structure is not considered a tax-avoidance scheme according to the practice of the Swiss Federal Tax Administration. In particular the two following basic structures will probably be considered as tax avoidance schemes:

- The funds are raised by a foreign vehicle (special purpose vehicle or SPV) that has one single purpose – to issue one bond and to transfer the funds to a Swiss company.
- The funds are raised by a foreign subsidiary of a Swiss company and the bond is guaranteed by the Swiss parent company. Swiss tax authorities do not accept such a structure, unless the funds raised are used abroad.

Structures involving a foreign SPV must be carefully investigated on a case-by-case basis and it is advisable to obtain an advance tax ruling from the Swiss tax authorities.

In recently ruled cases the Swiss Federal Tax Administration accepted a foreign vehicle as a lender under a loan facility although the foreign vehicle was being refinanced by collective fundraising schemes (but the foreign vehicle was not issuing sub-participations in its portion of the loan facility) based on the following criteria:

- the foreign vehicle must be a multi-purpose vehicle that is not established for one specific refinancing transaction only and that has a record of its issuing activity;

- the owners of the foreign vehicle are independent from the Swiss borrower under the loan facility and from the other lenders;
- the portion of the loan is recorded as an asset in the balance sheet of the foreign vehicle and the foreign vehicle bears the full debtor loss risk;
- the foreign vehicle's equity is the counterparty risk of the investors under the collective fundraising scheme and the Swiss borrower does not secure such counterparty risk.

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This practice of the Swiss Federal Tax Administration offers the opportunity for Swiss companies to be financed under market conditions on the growing international market by financial institutions that do not qualify under the narrow notion of banks within the meaning of Swiss Withholding Tax Law and Swiss Stamp Duty Law.

For foreign branches of Swiss banks, the funding by way of collective fundraising schemes does not trigger Swiss withholding tax and stamp duty issues if the foreign branch qualifies as a bank pursuant to the laws of the jurisdiction in which it accounts for the loans and if it carries on genuine banking activity there.

Securitization

Securitization schemes are also reviewed by Swiss tax authorities under tax avoidance criteria, in particular to determine whether a securitization structure is subject to Swiss withholding taxes and stamp duties. A favourable tax ruling confirming that the securitization structure does not constitute a tax avoidance scheme may be obtained even though proceeds are being used in Switzerland and the funds are raised through a foreign SPV provided that the following particular conditions are met:

- the transfer of the assets to the SPV is at arm's length;
- the assets transferred are eliminated from the financial statements of the originator and are replaced by the sales price;
- the risk for the assets, in particular the bad debt risk, must be fully borne by the SPV; and
- no obligation exists on the part of the originator to take back the assets.

In other words, there must be an irrevocable transfer of assets and of all related risks, that is, a true sale. If this condition is met, Swiss tax authorities even accept the securitization of receivables derived from mortgage-secured loans.

Avoiding adverse consequences

Debt funding of Swiss companies by non-Swiss lenders raises various Swiss withholding tax and stamp duty issues. In order to avoid adverse Swiss tax consequences, any debt financing of Swiss companies from abroad should be structured accordingly. In certain cases it is advisable to obtain an advance tax ruling from the Swiss Federal Tax Administration. ■