Recent Developments

Switzerland

REVISED TAX RULES ON BONDS, DERIVATIVES AND HYBRID PRODUCTS

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I. INTRODUCTION

Bonds, notes and derivative financial instruments may be subject to Swiss income taxes, withholding taxes, as well as stamp duties on capital issuance and transfer of securities. Up until recently, the relevant tax rules were found in (1) the income tax statutes of the Swiss Confederation as well as the 26 cantons, (2) the Federal Withholding Tax Act and the Implementing Ordinance thereunder and (3) the Federal Stamp Duty legislation. In addition, various circular letters issued by the Federal Tax Administration (hereinafter: FTA) and the cantonal tax authorities gave certain guidance on the interpretation of the relevant notions of "bond", "interest from accounts receivable", and "bond with predominant single interest payment".

In reaction to the rapid development of the capital markets and the wide range of innovative financial products sold by both Swiss and foreign issuers in Switzerland, on 12 April 1999 the FTA issued a new Circular (hereinafter: Circular 4) on the treatment of bonds and derivative financial instruments for purposes of federal direct tax (income tax), federal withholding tax and federal stamp duties. Circular 4 replaces FTA Circular 6 dated 15 December 1992 on the federal income tax treatment of bonds with predominant single interest payment and FTA Guideline dated 15 March 1993 concerning the withholding tax and stamp duty treatment of bonds combined with options.

Before addressing the details of Circular 4, this article will summarize some basic definitions and tax principles pertaining to bonds and derivatives.

II. BASIC DEFINITIONS AND TAX PRINCIPLES

A. Bonds, cash bonds and private placements

Swiss issuers of bonds are liable to a one-time federal capital stamp duty as described below. Swiss and foreign bonds are taxable securities for purposes of the federal stamp duty on the transfer of securities, which is imposed if a domestic securities dealer (as defined in the Stamp Duty Act) is involved in the transaction as either a party or an intermediary. Interest paid on bonds issued by domestic issuers or debtors is subject to 35 per cent federal withholding tax.[2] The withholding tax is an obligation of the debtor of the taxable interest payment. The debtor must reduce the taxable payment by the withholding tax and remit the tax to the FTA. Domestic creditors may either obtain a full refund of the withholding tax or credit the tax against their personal income tax liability. Non-resident creditors may qualify for a full or partial refund under an applicable tax treaties.

Domestic issuers or debtors essentially include natural and legal persons which have their domicile, permanent abode or legal seat in Switzerland or which are registered as a business enterprise with the Swiss commercial register. Legal entities incorporated abroad are considered "domestic" when they are effectively managed from Switzerland and conduct a business activity in Switzerland.

The withholding tax and stamp duty legislation provides for a broad definition of the notion of "bond". Bonds are defined as written debt instruments for fixed amounts issued in a multiple of units for the purpose of collective debt fundraising, providing a collective investment opportunity or consolidation of debt obligations. A new FTA Guideline issued in April 1999 distinguishes between (normal) bonds, cash bonds and individual debt obligations.[3]

"Normal" bonds are issued in a multiple of instruments under identical conditions. A normal bond is based on a single credit transaction. For withholding tax and stamp duty purposes, a Swiss debtor which raises debt funds is deemed to issue a bond if:

- written debt instruments are issued;
- funds are borrowed from more than 10 creditors (Swiss and foreign regulated banks are not counted as creditors for this purpose); and
- the total borrowed funds amount to at least CHF 500,000.

The issuer is liable to a 0.12 per cent capital stamp duty on the nominal value for each full or partial year of the maxi-

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2. Withholding tax is also raised on interest paid on Swiss bank accounts or deposits. However, interest paid on ordinary loans and advances is generally not subject to withholding tax.
3. FTA Guideline S-02.122.1 (4.99), Section 1 ("bond defined").

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mum term of the bond. Interest payments are subject to a 35 per cent withholding tax.

Cash bonds are issued in a multiple of instruments on an ongoing basis and under variable conditions. For withholding tax and stamp duty purposes, a Swiss debtor (other than a regulated bank) is considered to issue a cash bond if:
- funds of an aggregate amount of at least CHF 500,000 are borrowed under variable conditions;
- such funds are borrowed from more than 20 creditors (other than Swiss or foreign regulated banks); and
- such borrowings are evidenced by written debt instruments.

The issuer is liable to a 0.06 per cent capital stamp duty on the nominal value for each full or partial year of the maximum term of the bond. Interest payments are subject to a 35 per cent withholding tax.

Individual debt obligations include single loan transactions and private placements of debt in exchange for the issuance of debt notes. The withholding tax and stamp duty treatment of such transactions depends on the terms of the basic financing agreement and on the debt financing activities of the issuer. *Single loans* not incorporated in a written debt instrument are not considered to constitute private placements. However, any refinancing of such loans through the assignment of partial claims constitutes a taxable bond if the number of creditors (other than banks) granting such refinancing exceeds 10. If a *private placement* involves the issuance of written debt instruments, the number of such instruments issued in one private placement is deemed to represent the number of creditors. Thus, for withholding tax and stamp duty purposes a private placement is considered a taxable bond if it involves the issuance of at least 11 written debt instruments by the main lender. The issuance of private placement bonds or notes by domestic issuers is subject to a 0.12 per cent capital stamp duty. Interest payments are subject to a 35 per cent withholding tax.

Moreover, taxable bonds may include money market papers and registered book claims against Swiss debtors. *Money market papers* are debt securities, the term of which does not exceed 1 year (e.g. domestic bills of exchange, treasury bills, banker's acceptances, commercial papers and certificates of deposit). *Registered book claims* are not securities, but rather claims entered in a debt register. Their fixed term does not exceed 12 months.

The criteria for stamp duty and withholding tax liability of such instruments issued by Swiss issuers depend on whether they are issued in series or on an ongoing basis. Money market papers or registered claims issued in series of identical papers or claims constitute a bond if the total funds raised thereby amount to at least CHF 500,000 and there are more than 10 creditors (other than banks). If the instruments are issued on an ongoing basis under variable but similar conditions, a taxable cash bond is created when the total debt raised thereby amounts to at least CHF 500,000 and the number of creditors (other than banks) exceeds 20. The capital stamp duty amounts to 0.06 per cent of the nominal value, calculated pro rata at 1/360 for each day of the instrument's term.

Any bonds issued by a foreign affiliate of a Swiss parent company may be deemed, for Swiss withholding tax and stamp duty purposes, to be issued by the Swiss parent directly (with the consequence that capital stamp duty is imposed upon issuance and a 35 per cent withholding tax is imposed on interest payments), if both of the following conditions are met:
- the bond is guaranteed by the Swiss parent; and
- the proceeds of the bond are directly or indirectly received by the Swiss parent.

B. Income from capital versus capital gain

As a general rule, investment income (e.g. dividends and interest) is taxable to Swiss individual and corporate taxpayers at ordinary income tax rates on the federal, cantonal and communal levels. On the other hand, capital gains realized on debt (or equity) securities by individuals who hold such instruments in their private property are exempt from federal and cantonal/communal income taxes. However, this exemption does not apply if the individual concerned is considered a professional trader in securities for income tax purposes, in which case the gain is taxed as income from a (quasi) professional activity. Otherwise, capital gains on movable assets and rights including securities are not subject to special gains taxes.

The distinction between income and gain is also essential in the context of federal withholding taxes. Generally, interest paid on any type of collective debt (e.g. bonds, notes and instruments similar to those described in II.A.) issued by a Swiss resident is subject to a 35 per cent withholding tax. The withholding tax regulations clarify that any benefit of a monetary value passing from the issuer to the creditor based on a bond obligation other than the repayment of principal (nominal value) is considered taxable investment income (i.e. interest). However, the withholding tax law and the federal income tax law provide for an exemption of original issue discount (hereinafter: OID), provided that such discount does not exceed 0.5 per cent per year (based on the bond's minimum term) of the initial investment value.

C. Zero bonds, discount bonds, bonds with redemption premium and bonds with predominant single interest payment

As mentioned above, taxable interest income from bonds, notes, and similar debt instruments is considered to include all amounts paid by the issuer to the taxpayer in excess of the principal amount (nominal value) of the instrument. Thus, the notion of taxable interest income for income tax and (where applicable) withholding tax purposes not only includes the periodic interest coupons, but also OID typically provided on zero-bonds and low-interest coupon bonds, as well as premiums paid by the issuer on redemption or repayment of the debt instrument. Normally, such premiums are taxable in the hands of the (private) investor which holds the

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instrument at the time the premium is paid. The same holds true, for income tax purposes, for OID. If the instrument is issued by a Swiss issuer, the OID is also subject to a 35 per cent federal withholding tax, which is due from the issuer upon repayment or redemption. The issuer must charge the withholding tax to the holder of the instrument; failing this, the OID would be considered a benefit after tax, which in turn would raise the effective withholding tax rate to approximately 53.8 per cent.

It is not unusual for bonds and notes to combine a below-market periodic interest coupon with either OID or a premium payable on redemption or repayment (often referred to as "mixed bonds"). This situation is addressed by Article 20 (1)(b) of the Federal Direct Tax Code (hereinafter: FDTC), which provides that benefits realized by the holder of a bond with a predominant single interest payment upon the alienation or repayment of the instrument are taxable as income. Hence, a private investor will not realize a tax-free capital gain. Circular 4 clarifies that a bond has a predominant single interest payment when more than 50 per cent of the total compensation for the lender as of the issuance date (or based on the pricing conditions of the issue) consists of either OID or repayment premium. Zero-coupon bonds and most money market papers obviously fall under these rules.

Bonds with a low interest coupon are usually issued at a discount or repaid with a premium. They must be analyzed to determine whether the periodic coupon or the single interest component is predominant. Such analysis is made on the basis of an analytical (finance-mathematical) calculation of the instrument's overall yield to maturity. Such yield is determined as of the instrument's date of issuance and takes the following elements into account: issuance price, periodic and constant interest payments (i.e. a maximum of 1 year between two payments), redemption/repayment price and duration.

Example 1

Principal amount	CHF 1,000
Term	6 years
Interest coupon	CHF 30 per year
Issuance price	CHF 788.80
Yield to maturity on CHF 788.80	7.5 per cent per year

Periodic interest of CHF 30 per year = 3.8 per cent of issuance price = more than 50 per cent of yield to maturity. Therefore, FDTC Article 20 (1)(b) is not applicable.

Example 2

Principal amount	CHF 1,000
Term	6 years
Interest coupon	CHF 30 per year
Issuance price	CHF 1,000
Repayment amount	CHF 1,326

Yield to maturity including repayment premium = 7.5 per cent per year
Annual interest coupon of CHF 30 = 3.0 per cent of initial investment

Therefore, repayment premium (single interest component) = 4.5 per cent = more than 50 per cent of total yield to maturity. Therefore, FDTC Article 20 (1)(b) is applicable.

III. TAX TREATMENT OF BONDS, DERIVATIVES AND STRUCTURED PRODUCTS

A. Bonds

1. Ordinary bonds and mixed discount bonds without predominant single interest payment

Periodic interest payments made on such bonds are subject to (1) withholding tax if the bond is issued by a Swiss issuer and (2) income tax at the level of the bond holder. The same holds true for one-time interest payments in the form of OID or repayment/redemption premium. OID of up to 0.5 per cent per year is exempt from withholding tax, but is nevertheless subject to income tax. Capital gains realized by a private bond holder upon disposal of a bond prior to maturity are exempt from tax.

2. Discounted or zero-coupon bonds and mixed bonds with predominant single interest payment

The compensation paid by the issuer in form of OID is subject to income tax (and withholding tax if the bond is issued by a Swiss person) at the time the bond matures. In addition, in the case of a disposal of the discounted bond by its private holder prior to maturity, the difference between the acquisition cost and the higher sale proceeds is taxed as income. If the instrument is denominated in a foreign currency, the taxable amount is determined in Swiss Francs based on the exchange rates prevailing on the dates of the purchase and sale of the instrument. Costs which are allocable to the purchase and sale of the instrument (e.g. bank commissions) are deductible. If the sale generates a loss (i.e. a negative difference between acquisition cost and sale proceeds), the private holder may set off such losses against income realized on other Swiss or foreign instruments with predominant single interest payment (including periodic interest earned on such instruments) in the same taxable period.

B. Derivative financial instruments

The FTA characterizes derivatives as financial instruments the value of which is dependent upon that of another underlying commodity (e.g. shares, bonds, precious metals, currencies, interest rates or stock indices). Derivatives are used for hedging and transferring risks, speculation or matching of terms or currencies for claims and obligations. The FTA draws a basic distinction between futures (which include standardized futures traded on an exchange, as well as forward contracts traded over the counter) and options.

A *future* basically stipulates mutual obligations of two parties to either supply or purchase a fixed amount of a defined underlying commodity at a pre-agreed price on a fixed future date.

An *option* is defined as a future that is subject to a condition. The buyer of the option acquires the right (but assumes no obligation) for payment of a premium, to purchase (call option), or to sell (put option) a fixed amount of an underly-

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ing asset on (European-style option) or until (American-style option) a fixed date at a fixed price. Options may be agreed individually between the parties (often referred to as OTC options) or be standardized (often referred to as traded options). Warrants are options that are incorporated in a separate security. The exercise of an option generally leads to a delivery (sale) of the underlying commodity by the writer of the option to the option holder. However, the exercise of an option on an abstract asset (such as an interest rate or stock index) gives rise only to a cash settlement.

Both futures and options are governed by the same tax rules. Their creation does not give rise to any stamp duties. Futures and options including warrants are not taxable securities for purposes of the securities transfer stamp duty. Any benefits earned by private individuals in connection with futures, forwards and options are classified as capital gains and are thus exempt from income tax (unless the individual is classified as a professional trader) and withholding tax. The gains classification includes the option premium received by the writer of the option. On the other hand, private individual investors cannot deduct any losses suffered in connection with derivatives.

C. Combined or "hybrid" financial products

Hybrid products combine a bond with a derivative. The FTA distinguishes between three different categories of hybrid products:
- derivatives with guaranteed capital and "non-classical" option bonds and convertible bonds;
- "classical" option bonds and convertible bonds; and
- "reverse convertibles" (with or without guaranteed capital).

1. Derivatives with guaranteed capital and non-classical option bonds and convertible bonds

a. *Generally*

Such instruments are a combination of a bond element with an option or a conversion or exchange right, which enables the investor to participate in the development of the underlying commodity, while the bond element guarantees a full or partial repayment of the initial investment. Circular 4 mentions the following as examples of derivatives with capital guarantee: GROIs (guaranteed return on investment notes); CPUs or CPNs (capital protected units or notes); PIPs (protected index participation units); and IGLUs (index growth linked units), which all have a term of 1 to 2 years. Non-classical option bonds may be issued in two separately tradable securities or in one single security. The conversion or exchange right of non-classical convertible bonds cannot be separated from the bond; the exercise of the conversion or exchange right extinguishes the bond obligations and the bond holder becomes a shareholder.

The income and withholding tax treatment of all these instruments depends essentially on their "transparency" for tax purposes. An instrument is considered transparent if the value on issuance of its "bond" and "derivative" components can be determined separately. This is rather easy where the different components are traded separately. In the case of convertible or exchangeable bonds (where the conversion or exchange right cannot be physically detached), transparency is recognized if the issuer discloses the different elements (in particular, the guaranteed repayment amount, the issuance value of the bond component and the interest rate used as the basis for the bond valuation) in the issuance prospectus and other offering materials. Alternatively, transparency may be achieved by disclosing the aforementioned elements in writing to the Swiss tax authorities. The FTA must be able to verify the values attributed to the bond and derivative components based on the analytical (finance-mathematical) computation. The only element that is relevant for the classification as a transparent product is the theoretical OID, which is based on a yield computed at a fair market rate of interest.

b. *Tax treatment of transparent derivatives with guaranteed capital, non-classical option bonds and non-classical convertible or exchangeable bonds*

For tax purposes, transparent products are divided into bond and derivative portions. Any gains or losses realized by a private individual on the derivative portion are tax-free. The bond portion of the transparent product is taxed under the rules pertaining to (pure or mixed) discount bonds.[4] Income tax and withholding tax (if applicable) are imposed on the periodic interest payments and on the one-time interest component. The guaranteed repayment amount is deemed to represent the bond's nominal value. If the single interest component represents more than 50 per cent of the total compensation on the bond's initial value, a disposal of the instrument prior to maturity will be taxed under FDTC Article 20(1)(b).

The theoretical issuance price of the bond portion is deemed to be equal to the final price on the first day the instrument is traded "ex option" on the exchange.

In the case of instruments the components of which are not separately traded (e.g. exchangeable or convertible bonds), the issuance price of the bond component is calculated "analytically". The guaranteed repayment amount is discounted at the market interest rate applicable to investments that are comparable in terms of the duration, the currency and the issuer's credit rating.

The amount of income taxable to a private investor on disposal of an instrument with predominant single interest payment under FDTC Article 20(1)(b) corresponds to the difference between the acquisition cost and the exchange price "ex option" on the day of sale.

If the different components are not traded separately, the income taxable upon disposal or repayment of an instrument with predominant single interest payment must be determined "analytically" since the exchange price includes the value of the derivative portion as well. In addition, the analytical computation of the acquisition cost and the sale value of the bond portion must be modified in order to take into

4. See II.C.

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account the fluctuation of the general interest rate. Circular 4 suggests a "modified differential taxation", whereby the original interest rate used for the bond valuation is adjusted quarterly by reference to the 5-year swap rate of the currency concerned. Banks must certify the relevant values as of the acquisition, sale or repayment in their statements to the taxpayer. If a (private) taxpayer fails to provide such certification or other evidence for the relevant values, that taxpayer will, in the event of sale or repayment of the instrument prior to maturity, be taxed pro rata temporis on a deemed market interest computed on the entire investment value (i.e. the bond and the derivative).

The bond portion is subject to capital stamp duty on issuance and may be subject to securities transfer stamp duty when an instrument is transferred for consideration.

c. *Tax treatment of non-transparent hybrid products*

If a hybrid financial product is not made transparent by the issuer, it will basically be treated as a bond with a variable return. Thus, the derivative element is considered as a variable component of the taxable return of the investment. In other words, the private investor will be taxed on all amounts received on the due date of periodic interest coupons, options, conversion or exchange rights or on maturity of the instrument in excess over the capital initially invested. In addition, such amounts are subject to withholding tax if the instrument is issued by a Swiss person. As non-transparent hybrid products are usually instruments with predominant single interest payment, they also fall under FDTC Article 20(1)(b). Thus, income tax is assessed upon the disposal or repayment of the instrument prior to maturity on the difference between the acquisition cost and the higher sale price of the entire instrument.

A bond with variable return is subject to capital stamp duty on issuance if issued by a Swiss person. Transfers of non-transparent hybrid products may also be subject to securities transfer stamp duty, if a Swiss securities dealer is involved in the transaction as a party or as an intermediary.

2. Classical option bonds and convertible bonds

The FTA treats option bonds and convertible bonds as "classical" instruments if all of the following conditions are met:

- the option bond or convertible bond is issued by a Swiss corporation;
- the option or conversion right attached to the bond entitles the holder to acquire newly issued shares in the Swiss issuer of the bond or in a Swiss or foreign affiliated company of the Swiss issuer; and
- the option bond or convertible bond is issued at par or at a discount of not more than 0.5 per cent per year of the instrument's term and is repaid at par, or is issued at par and repaid with a premium of not more than 0.5 per cent per year.

All other option bonds and convertible or exchangeable bonds are considered non-classical.

Contrary to non-classical options or convertible/exchangeable bonds, the discount component typically present in classical option bonds and convertible bonds is exempt from both personal income tax and withholding tax. In addition, a sale or redemption of a classical option bond or convertible bond by a private investor prior to maturity will never result in income taxation under FDTC Article 20(1)(b). Income tax and (if applicable) withholding tax is only due on the periodic interest payments.

Capital stamp duties and securities transfer stamp duties are imposed according to the general rules on bonds.

3. Reverse convertibles

Reverse convertibles combine a bond with a put option on an underlying commodity. The buyer of the instrument acquires a bond from the debtor and at the same time sells him a put option for the underlying asset. The debtor will exercise the put option on maturity of the bond if the market price of the underlying asset at that time is lower than the strike price, which corresponds to the repayment amount of the bond. Thus, the investor will on maturity either get a cash repayment of the bond (if the debtor forfeits the put option) or acquire the underlying commodity instead of the cash repayment (if the debtor exercises the put). A reverse convertible may also provide for a certain capital guarantee for the investor, which guarantee is achieved by an additional put option bought by the investor from the debtor.

Similar to derivatives with guaranteed capital and non-classical option bonds, convertibles and exchangeables, reverse convertibles may, for tax purposes, be divided into a taxable bond and a tax-free derivative (option or combination of options), provided that the instrument is made transparent by the issuer. Under the condition of transparency, the option premium paid by the issuer to the private investor is exempt from income tax and withholding tax (where otherwise applicable); taxation is limited to the interest on the bond portion, which would have been paid for an investment in a comparable straight bond of the same issuer with a similar term and in the same currency at market conditions. If the interest is paid as a one-time compensation, the "modified differential taxation" as described in III.C.1.b. is applied in each case of pre-maturity sale or redemption of the instrument. For tax purposes, the nominal value of the bond portion is usually equal to the entire amount invested in the reverse convertible. However, if the instrument includes a capital protection, such protection is the result of a (further) option and the nominal value of the bond element must be computed "analytically".

Non-transparent reverse convertibles are treated as bonds with a variable taxable return and are thus taxed according to the principles described in III.C.1.c. (i.e. ignoring the presence of a tax-free derivative component).

Capital stamp duties and securities transfer stamp duties are imposed according to the general rules on bonds.

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D. Special cases

Exhibit III to Circular 4 contains a list of special cases which will be amended from time to time based on new projects submitted to the FTA. Presently the special cases list describes the following types of financial products.

1. Index and basket certificates

Such certificates represent an investment in a stock market or in a basket of selected shares. They are substantially taxed as derivative instruments. Compensation payments (for dividends on the underlying shares) are taxable. Gains and losses realized by private individuals are tax-neutral.

2. Short-term reverse convertibles without guaranteed payments

The FTA treats such instruments (e.g. BLOCs, TOROs and CMMs) with a term of not more than 12 months as futures, not as hybrid products. The difference between the market value of the underlying commodity on issuance and the lower issuance price of the instrument is fully treated as a tax-free gain in the hands of private investors, even though it partly represents an interest component.

3. Bonds with "money-back" options

Option bonds which give the investor an alternative claim on a cash amount instead of the right to acquire the underlying asset are treated as normal option bonds. However, if the investor opts for the cash payment, such payment is fully taxed as interest.

4. Convertible bonds combined with put option for early repayment

The put option gives the investor the right to ask for early redemption of the bond on a date substantially prior to the ordinary maturity date at a price which exceeds the issuance value. Such convertibles are always treated as non-classical instruments. If the convertible over its entire term has a predominant single interest payment, the put option must be disregarded in the analysis. The instrument will be taxed according to the analytical method (modified differential taxation, see III.C.1.b.) if it is made transparent. However, if the put option is exercised, the bond repayment amount relevant for the tax computation is not the "analytical" value on early repayment, but rather the effectively repaid amount.

IV. CONCLUSION

The new Circular 4 of the FTA has clarified various tax issues connected with the use of derivative financial instruments and, in particular, hybrid products such as convertible and exchangeable bonds, and reverse convertibles. Specifically, it is no longer required that the bond and derivative components of such instruments be traded separately in order to distinguish for tax purposes between a taxable bond and a tax-exempt derivative, provided that transparency of the different components of the product is warranted. The author's own recent experience has shown, however, that foreign issuers of such non-classical instruments are often particularly hesitant to disclose all the information that is necessary to make the issue transparent and thus significantly more attractive from the tax perspective of Swiss private investors. Moreover, the analytical and modified differential taxation methods suggested in Circular 4 for non-classical transparent hybrid products impose significant administrative burdens not only on issuers and investors, but also on the banks through which the instruments are traded. How the application of those new rules will work in practice remains to be seen.

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