Financing Arrangements – Particular Swiss Tax Issues

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I Overview

Financing arrangements involving a Swiss tax resident party – whether inbound or outbound – rise a number of tax considerations, notably in the fields of direct taxes on income and capital, withholding taxes on capital income (dividends and interest), stamp duties on the creation or issuance of equity capital or certain debt obligations, stamp duties on the transfer of securities for consideration, and value added taxes.

II Income and Capital Taxes

1 General

Swiss resident taxpayers are subject to income taxes imposed at the federal, cantonal and communal level and to capital or net worth taxes at the cantonal and communal level. Corporate taxpayers are subject to corporate income taxes on their net profit, which substantially corresponds to the net profit reflected in the commercial financial statements, subject to certain adjustments for tax purposes. Corporate capital taxes are imposed on the net stockholders' equity at the end of the tax year.

2 Equity and debt

2.1 General

As far as financial arrangements are concerned, debt financing received is generally not taxed as equity and interest paid or accrued on debt obligations is recognised as a deductible business expense for income tax purposes. On the other hand, payments in respect of equity are treated as distributions (dividends) and cannot be deducted from the taxable net income. From the point of view of a Swiss corporate tax payer that grants financing to another corporate entity (whether Swiss or foreign), funding provided in the form of equity produces dividends, whilst funding provided in the form of debt generates interest.

2.2 Interest versus dividends

Interest is generally treated as ordinarily taxable income. However, dividends received by a corporate taxpayer may qualify for privileged tax treatment ("*Beteiligungsabzug*" or "participation relief") which is designed to eliminate the effect of the classical system of double taxation of corporate profits when earned and when distributed to the shareholders. In order to qualify for such tax relief, dividends must be derived from a participation in the capital of another corporate entity (Swiss or foreign), which represents either at least 20% of the capital of such entity or a fair market value of at least CHF 2,000,000. Neither is participation relief for qualifying equity investment dependent on any "subject to tax" or double taxation treaty requirements nor is the tax deductibility of debt interest paid subject to such conditions. The only significant restriction is imposed by the general rule that participation relief in respect of distribution received shall not be applicable if such distribution gives rise to a tax deduction at the prior level (i.e. is treated as interest expense in the hands of the company making the distribution). That rule has a rather significant impact on out-bound "hybrid debt" structures: Although the instrument issued by the foreign counterpart to the Swiss corporate investor may, for example, be designated as "preferred stock", the distributions received in respect of such preferred stock are not eligible for participation relief if the issuer can deduct the distributions as business (financing) expenses for its own income tax purposes. This raises yet another interesting issue: The foreign issuer of the "hybrid" instrument may, under the tax laws applicable to it, be treated as a "fiscally transparent" entity, i.e. income and expenses of the entity may not be taxable in its hands, but rather in the hands of its members or partners (example: "check-the box" treatment of LLCs under US federal income tax rules). The distri-

butions on the hybrid instrument may thus be treated as a tax-deductible item at the level of the partners/members of the look-through entity. We believe that this would not exclude the application of the participation relief at the level of the Swiss holder of the hybrid instrument.

2.3 Capital gains

Finally, the distinction between equity and debt capital may also be important for the tax consequences of a disposal of the investment: Capital gains derived from the sale of debt instruments (and non-qualifying equity investments) are included in the corporate's taxable net profit. On he other hand, capital gains from the sale of substantial equity participations (for those purposes, "substantial" means at least 20% of the capital stock of the underlying company) are eligible for participation relief, if the participation sold was held for at least one year.

2.4 Thin capitalisation rules and transfer pricing

The principle of tax deductibility of outgoing debt interest generally also applies in the context of debt financing by shareholders or other related parties. However, tax deductibility of interest paid to related parties is limited by "thin capitalisation" tax rules and special guidelines on arm's length interest rates, which are issued from time to time by the Swiss Federal Tax Administration ("FTA"). These limitations on interest deduction generally do not apply to debt provided by unrelated third parties, unless the third party financing is backed-up related parties. The Swiss thin capitalisation rules do not provide for any fixed debt-to-equity ratios. Instead, they set maximum debt funding rations separately for various asset categories. To the extent that such debt ratios are reached or exceeded by third party debt, there is no room left for tax-deductible debt funding by shareholders or related parties.

III Federal Withholding Taxes

1 General

The Federal Government imposes a withholding tax ("*Verrechnungssteuer*", "anticipatory tax") of currently 35% on the gross amount of certain types of capital income paid by Swiss resident persons.

2 Resident definition

Swiss resident persons include natural and legal persons that 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 resident when they are effectively managed in Switzerland and conduct a business activity in Switzerland.

3 Withholding tax obligation

The withholding tax is technically an obligation of the debtor of the taxable payment. However, the economic burden of the tax must be borne by the recipient of the taxable

payment. Therefore, the debtor has to deduct the tax from any taxable payments ("withholding") and remit it to the FTA. Any failure to deduct and withhold the tax due normally leads to the presumption that the debtor has effectively paid a net-of-tax benefit, representing 65% of the taxable amount. The taxable base is thus grossed up to 100%, leading to an effective tax burden of ca. 53.8%. The Withholding Tax Act expressly stipulates that any private undertakings that are designed to circumvent the obligation to charge the recipient of a taxable benefit with the burden of the tax are null and void.

4 Scope of application

The withholding tax applies to

a) dividends and similar distributions of profits or equity reserves, stock dividends (conversion of earnings or reserves into nominal share capital) and liquidation surplus (excess of net liquidation proceeds over nominal share capital);

b) interest paid on Swiss bank accounts or deposits; and

c) interest paid in respect of "bonds" or "debentures" issued by Swiss resident persons.

Interest paid in respect of single, private or commercial loans and credits is generally not subject to the federal withholding tax, unless the debt obligation in question is either recharacterised, for withholding tax purposes, into a "bond" or "debenture", or the borrower is considered to be a "bank" for withholding tax purposes.

5 Definition of "bond" for withholding tax purposes

The definition of the notion "bond" ("*Obligation*") for the purposes of the federal withholding tax and the federal stamp duties (see below) goes far beyond the general economic meaning of this term and plays a key role in many financing arrangements for Swiss resident borrowers. Any debt obligation that is issued, or deemed to be issued, by a Swiss resident issuer is subject to federal withholding tax on interest paid (and to capital stamp duty on the principal amount upon issuance, see below), if such obligation meets the criteria of a taxable "bond".

Generally, the Withholding Tax Act defines bonds as written acknowledgments of indebtedness (debt instruments) for fixed amounts issued in a multiple of units for the purpose of obtaining collective financing from investors at large, or of creation of collective investment opportunities, or of consolidation of liabilities; in particular, bonds issues, including bonds guaranteed by a mortgage pursuant to Art. 875 of the Swiss Civil Code, annuity bonds, mortgage bonds, notes, certificates and debt register claims. Taxable "bonds" also include

- bills of exchange,
- acknowledgments of indebtedness assimilated with bills of exchange and other discountable commercial papers issued in multiple instruments destined to be placed in the public;

- certificates evidencing sub-participations in claims arising from loans;
- debt register claims issued in multiple instruments with a view of obtaining collective financing from investors at large.

The FTA Guideline S-02.122.1 (issued in April 1999) distinguishes between normal bonds, cash bonds and individual debt obligations.

5.1 Normal bonds

"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 who raises debt funds is deemed to issue a bond if

i) written debt instruments are issued;

ii) funds are borrowed from more than ten creditors, other than Swiss and foreign regulated banks (for the definition of "bank", see below); and

iii) the total borrowed funds amount to at least CHF 500,000.

5.2 Cash bonds

„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

i) funds of an aggregate amount of at least CHF 500,000 are borrowed under variable conditions;

ii) such funds are borrowed from more than 20 creditors (other than Swiss or foreign regulated banks); and

iii) such borrowings are evidenced by written debt instruments.

5.3 Private placements of debt obligations

Single loans that are not incorporated in a written debt instrument are not considered to constitute taxable bonds. However, any private placements of debt in exchange for the issuance of debt notes and any refinancing of single loans through assignment of partial claims to more than ten investors (other than banks) constitutes a taxable bond. In a private placement, the number of debt instruments issued is deemed to represent the number of creditors.

5.4 Money market papers and registered book claims

Money market papers are debt securities with a term not exceeding 12 months (e.g. domestic bills of exchange, treasury bills, banker's acceptances, commercial papers, and

certificates of deposit). Registered book claims are not evidenced by a security, but rather represented through an entry in a debt register. Their fixed term does not exceed 12 months.

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 the number of creditors (excluding banks) exceeds ten. 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 (excluding banks) exceeds twenty.

5.5 Issuance of "bonds" through foreign entities

5.5.1 Foreign bonds with Swiss parent guarantee

A "bond" issued by a foreign affiliate of a Swiss parent company may be deemed to be issued by the Swiss parent directly, if the obligation is legally or economically (e.g. through a keep-well arrangement) guaranteed by the Swiss parent, provided further that the proceeds are directly or indirectly used to finance the Swiss parent's domestic business operations. Thus, the use of the bond proceeds by the foreign issuer to grant a loan to the Swiss parent will trigger a treatment of the Swiss parent as if it had issued the bond directly. On the other hand, if the foreign bond issuer applies the bond proceeds to finance (or re-finance) other non-Swiss affiliates or subsidiaries of the Swiss parent, such a transaction is generally not treated as a financing of the Swiss parent, even if the transaction effectively allows the foreign affiliates to redeem their bona fide existing debt obligations from their Swiss parent.

5.5.2 Structured financing and securitization transactions

Financing transactions on behalf of a Swiss resident "originator" are sometimes organized through a foreign vehicle that is not a subsidiary of, or otherwise affiliated with, the Swiss originator. Typically, the financing vehicle would be a foreign entity, the capital of which is either controlled by a charitable trust or an independent financial institution. The FTA distinguishes between loan-model securitization (the foreign vehicle grants a loan to the Swiss "originator" and refinances itself through the issuance of a bond) and asset securitization (the foreign vehicle uses the proceeds of the bond financing to acquire assets from the Swiss "originator" in a "true sale" transaction).

In the case of loan-model transactions, the FTA applies a "look-through" approach based on tax avoidance considerations, if the foreign bond issuer is effectively a "single purpose vehicle" (SPV), i.e. when the principal business function of the entity consists of providing debt funds to the Swiss "originator". In such circumstances, where the re-financing of the SPV in the capital market solely serves the financing needs of the Swiss originator, the FTA considers the financing of the Swiss originator and the refinancing through a bond issue to form an economic unit. Accordingly, for withholding tax (and capital stamp duty) purposes, the bond is deemed issued directly on behalf of the Swiss originator.

However, no Swiss capital stamp duties or withholding taxes become due if the issuer of the bonds/notes is a (foreign) bank or finance company which extends loans to multiple borrowers and refinances itself through issuance of debt securities in the capital market, if such refinancing is made in the issuer's own, independent discretion and in the course of its ordinary business activity. The relevant criterion for the FTA is a reasonable separation of the financing activity of the originator from the refinancing activity of the issuer, adapted to the economic facts and circumstances of the concrete case. In particular, so-called „Conduit-SPVs" – foreign entities, the principal business activity consists of providing structured financing which, however, is not limited to one originator but may be made available to multiple originators - are treated as if they were normal, independent financial institutions, provided that the Swiss originator has no influence whatsoever (e.g. by nomination of directors, contractual rights, financial control etc.) in the corporate decision making of the "conduit-SPV".

The qualification of a non-Swiss resident bond issuer as a SPV is not relevant, for withholding tax and stamp duty purposes, if the legal relationship between the foreign bond issuer and the Swiss originator is not a debtor/creditor relationship. Therefore, if the funding transaction between the foreign bond issuer and the Swiss originator is substantially structured as a "true sale" - which would normally be the case in an asset securitization, where the originator generates cash by selling certain income-producing assets, such as credit card claims, mortgage loan receivables etc. to the funding vehicle - the foreign bond issuer may even be a typical SPV. The FTA has set a number of criteria for recognition of a "true sale", such as:

- Full transfer of ownership of the underlying assets;
- Full assumption of all economic risks associated with the assigned assets by the funding vehicle (i.e. exclusion of any recourse to the originator in case of defaults on the assigned claims and receivables);
- Arm's length contractual conditions on the assignment/sale of assets;
- Due reflection of the assignment of assets and the consideration received in the originator's accounts;
- Absence of revocation rights concerning the assignment of assets and assumption of associated risks.

The originator may continue to manage the assigned assets and make cash collections on behalf of the assignee/bond issuer under a service agreement with the latter, provided that the relating cash flows are booked into separate trust accounts specifically designated to the assignee.

6 Withholding tax issues in connection with syndicated loan facilities

6.1 Bond qualification

One of the critical issues in connection with the arrangement of syndicated loan facilities for a Swiss resident debtor is to avoid that the loan facility is qualified as a "bond" for

Swiss withholding tax (and stamp duty) purposes. As outlined above, the raising of debt funds of more than CHF 0.5 million on behalf of a Swiss resident borrower may result in a taxable bond, if based on a single transaction funds are borrowed from at least eleven different lenders at identical conditions, or if on an ongoing basis ("cash bond") funds are borrowed from at least 21 lenders at variable conditions – provided, however, that any lenders that qualify as "banks" are not taken into consideration when counting the number of relevant lenders. "Banks" for this purpose include the Swiss National Bank and all Swiss merchant banks and savings institutions licensed to operate as banks under the Swiss federal Banking Act, as well as a wide range of foreign banks including the Bank of International Settlement, public foreign central banks, state or inter-state monetary funds, development banks, and private financial institutions which are fully subject to banking regulations in their country of incorporation (if such regulations exist in the country of origin) and which exercise a genuine banking activity as their principal business purpose. Therefore, the syndicate loan documents will typically ensure that the lender syndicate will at no time include more than ten non-bank members, or more than twenty non-bank members in the case of revolving credit facilities.

6.2 Sub-participation of credit

The loan documentation for a Swiss resident borrower will typically also provide that no member of the initial lender syndicate shall be entitled to subsequently assign or sub-participate any credit portions to any person other than qualifying banks. In this regard it should be noted that the assignment and sale or "sub-participation" by a Swiss bank of partial claims in a credit facility granted to a Swiss or foreign borrower may itself result in the Swiss bank being deemed to issue a taxable bond, if the funds so re-financed exceed CHF 0.5 million and the number of partial claims so created and sold (excluding partial claims sold to other qualifying banks) amounts to at least eleven or 21, respectively. Independently of whether the Swiss syndicate member creates a taxable bond through the assignment of partial claims, the sub-participants/assignees will be taken into account also for determining the number of non-bank creditors of the original Swiss borrower.

6.3 "Customer deposits"

It must further be noted that even in the absence of a taxable "bond", the interest paid by a Swiss resident borrower may become subject to withholding tax if the underlying debt is qualified as a "customer deposit" with a "bank" for withholding tax purposes. Debt funds provided by regulated Swiss or foreign banks will never qualify as "customer deposits." However, interest debt funds provided by non-banks to Swiss regulated banks are "customer deposits". Even a Swiss borrower that is not a regulated bank according to the Banking Act may be deemed to be accepting taxable customer deposits, if such borrower is qualified as a "bank" for withholding tax purposes. This will be the case if a Swiss borrower, on a continuous basis, accepts interest-bearing debt funds in aggregate of at least CHF 500,000 from more than twenty lenders (other than Swiss and foreign regulated banks).

6.4 Repackaging

Recent transactions in Switzerland have shown a tendency towards the use by some sending syndicate member banks, for their own re-financing, of "re-packaging" structures

whereby such lender banks assign and sell a substantial portion of their credit engagement to a special vehicle (often a SPV), which will in turn re-finance itself through a bond issue ("credit-linked notes") in the capital market. Whether or not such notes issue for the re-financing of a credit portion ultimately has a detrimental tax effect on the original Swiss borrower depends on the circumstances of the individual case. Critical elements are, for example, voting rights of the note holders in the event of default of the original Swiss borrower.

6.5 Up-stream and side-stream security

Further critical issues may arise when a Swiss resident co-borrower or guarantor provides upstream or cross-stream collateral (asset pledges, guarantees etc.) to lenders in order to secure debt obligations of other (especially foreign) group companies. Not only are such transactions subject to limitations under corporate law (company purpose; capital protection; availability of freely distributable reserves), but they may also lead to the assessment of constructive dividends, for tax purposes.

IV Federal Stamp Duties

1 Capital issuance stamp duties

Subject to issuance stamp duties are

- Equity contributions to Swiss resident corporate issuers, whether in exchange for the issuance of shares or similar equity securities or capital interests or as informal capital contributions. The stamp duty amounts to 1% of the net contribution received and is payable by the issuer within 30 days of receipt of the contribution or registration of a share issue in the commercial register. Exceptions are provided for example for corporate restructurings and the initial contribution up to CHF 250'000.

- The issuance by Swiss resident issuers of bonds, documents certifying sub-participations in loan receivables from domestic borrowers, and money market securities. The stamp duty is imposed on the principal debt amount and amounts to 0.12% for each full or broken year of the instrument's maximum term in the case of "straight" bonds, notes and registered book claims, and 0.06% in the case of cash bonds and deposit certificate. On money market papers, the duty is imposed at 0.06% and calculated at 1/360 for each day of the instrument's term. The duty becomes due 30 days after issuance of the taxable debt instruments. The definitions of "bond", "cash bond", "money market paper" etc. are identical to those used for the purposes of the federal withholding tax.

2 Securities transfer stamp duties

The transfer stamp duties are levied upon the transfer of ownership of taxable securities for consideration in the "secondary market" (primary market or issuance transactions are generally exempt), provided that either party to the transaction, or an intermediary is a Swiss securities dealer for stamp duty purposes.

Taxable securities include

- all kinds of corporate equity securities or instruments (in particular including membership quotas of limited liability companies, shares, participation certificates etc.);
- “bonds” in the above-described, broad meaning of the withholding tax and stamp duty legislation;
- mutual fund shares or units; and
- certificates of sub-participation in any of the aforementioned instruments.

These instruments are taxable instruments irrespective of whether they are issued by a Swiss or a foreign resident issuer.

Securities dealers for stamp duty purposes are

- Banks and quasi-banking companies as defined in the federal Banking Act, and the Swiss central bank;
- domestic individuals, legal entities, partnerships, domestic branches of foreign enterprises, whose operation consist exclusively or mainly trading (“Händler”) or acting as an intermediary (“Vermittler”) with taxable securities;
- domestic corporations and pension funds, whose assets consist taxable securities with a total book value of more than CHF 10 million;
- foreign members of a Swiss stock exchange with regard to the domestic taxable securities that are traded on that stock exchange (remote members);
- the Federal Government, the Cantons, Municipalities, and domestic social insurance institutions.

It is the securities dealer who is subject to tax: The half amount of the tax is due

- if acting as a intermediary (“Vermittler”): for each contract party that is neither a securities dealer nor an exempted investor (“befreiter Anleger”);
- if acting as a contract party (“Vertragspartei”): for itself and for the counter party that is neither a securities dealer nor an exempted investor (“befreiter Anleger”).

Banks and quasi-banking companies as defined in the Bank Act and the Swiss central bank, and domestic individuals, legal entities, partnerships, domestic branches of foreign enterprises, whose operation consist exclusively or mainly trading (“Händler”) with taxable securities don’t due the half amount of the tax for itself if taxable securities are bought for or sold from its trading account (“Handelsbestand”).

Exempted investors (“befreite Anleger”) are

- foreign states and central banks;

- domestic and foreign investment funds in the meaning of the Investment Fund Act;
- foreign pension funds and social insurance institutions;
- foreign life insurance companies

The stamp duty is imposed at a rate of 0.15% for domestic securities and at 0.3% for foreign securities and calculated on the consideration received. In contrary to withholding tax, there is no obligation of the tax payer to shift the tax burden forward to the contract parties and counter parties respectively. In practice, the investor generally bears the tax burden.

Exceptions from the transfer stamp duty are provided for example

- issuance of securities (“primary market exemption);
- contribution of taxable securities in exchange for domestic corporate shares or interests in investment funds;
- return of securities for redemption/cancellation;
- dealing with money market papers;
- acting as intermediary (“Vermittlung”) or buying and selling of foreign bonds as far as the buyer or seller is a foreign contract party.

In connection with foreign taxable securities the half amount of the tax is not due if the foreign contract party is a foreign bank or a foreign broker.