# Swiss Supreme Court rules on the tax treatment of a profit participating loan

By Peter Reinarz
*Reinarz Tax and Legal, Zurich*
**peter@reinarz-taxlegal.com**

Published by the IBA Taxes Committee on Friday 8 January 2021

In a decision rendered on 31 March 2020 (case no 2C_578/2019), the Swiss Federal Supreme Court (FSC) had to deal with the Swiss tax treatment of a profit participating loan (PPL), specifically from a dividend withholding tax point of view, which had been granted to a Swiss corporation (SwissCo) by the German parent company and three German resident individuals, all belonging to the same family.

Based on the concrete factual circumstances of the case, the FSC confirmed the prior judgment of the Federal Administrative Court (FAC) dated 15 May 2019 (case no A-6360/2017). It concluded that the amounts of interest paid by SwissCo under PPLs granted by the parent company and by three individuals constituted constructive dividends, which were therefore subject to federal dividend withholding tax to the extent that the remuneration for the loans exceeded the 'safe harbour' interest rate for loans granted by shareholders and persons close to the shareholders, as suggested by a transfer pricing guideline published by the Swiss Federal Tax Administration (FTA) and amended from time to time.

### *Facts of the case*

Originally, SwissCo had been set up as a limited liability company. In addition to the formal company capital, SwissCo had issued additional, non-voting shares (participation certificates) to its German parent company and to three German resident individual investors in the aggregate amount of CHF 1.82 million, comprised of 1,820 participation certificates of CHF 1,000 nominal value each, 221 of which were apparently held by the parent company. It appears that the individual investors did not hold any formal, voting shares (capital quotas) in SwissCo. Further, it remained uncontested in the proceeding that the individual investors had to be regarded as persons close to the parent company. At some point, SwissCo was converted into a joint stock corporation. At that occasion the former participation certificates (non-voting equity) were converted into PPLs, which provided for an annual interest coupon of seven per cent.

In 2015, the FTA carried out a tax audit of the accounts of SwissCo for the years 2010-2014. This resulted in a claim against SwissCo in the amount of some CHF 94,000 for withholding taxes on constructive dividends. The FTA held that SwissCo had paid excessive amounts of interest to its lenders under the PPLs, to the extent that the seven per cent interest rate exceeded the safe harbour interest rates published by the FTA for the years under review.

According to the FTA, the portion of the loan interest that exceeded the published safe harbour interest rates constituted constructive dividends for the benefit of a shareholder or persons close to the shareholder, as that exceeding amount of interest was not at arm’s length. SwissCo brought an appeal to the FAC against the withholding tax assessment by the FTA, albeit without success.

### *Ruling of the Federal Administrative Court*

The FAC rejected the main argument invoked by SwissCo – that PPLs had to be treated in a different fashion than ordinary shareholder loans as far as transfer pricing principles are concerned. The FAC reiterated the four criteria of a taxable monetary benefit, such as a constructive dividend, for federal withholding tax purposes:

1. the company grants a monetary benefit without consideration of equivalent value, which does not constitute a repayment of contributed/paid-up capital, and which therefore reduces the company’s net assets;
2. the monetary benefit is granted to a shareholder, either directly or indirectly via a person or enterprise that is affiliated with/close to such shareholder;
3. the benefit has its reason and cause in the equity participation relationship between the company and its shareholder: ie, a comparable benefit would not have been granted under the same circumstances to an unrelated third party (in that sense, the benefit must appear extraordinary or unusual); and
4. the unusual, extraordinary character of the benefit, in particular the disproportionality between the benefit granted and the compensation received by the company, must have been recognisable by the responsible executive organs of the company.

The FAC stressed that these four cumulative criteria for a constructive dividend must be reviewed solely from the perspective of the company – ie, the grantor of the benefit – and the perspective of the beneficiaries is not relevant for the analysis.

The first question – whether there is a proper economic balance between the benefit granted by the company and the compensation received – therefore is determined based on the general dealing at arm’s-length standard (comparison with (hypothetical) transactions between unrelated third parties at market conditions).

The jurisprudence recognises that there is generally a certain range of market-standard transfer prices; the determination of an imbalance (ie, a constructive dividend) requires a clearly apparent, manifest disproportion between the benefit granted and the consideration received. The market conformity of loan interest paid to a shareholder, or to a person close to a shareholder, is to be determined in consideration of the creditor and country risks, as well as collateral provided for the loan (if any).

The FAC pointed to the annually published maximum arm’s-length interest rate guidelines of the FTA. While those guidelines are not legally binding on the courts, they are generally to be followed, except where they do not provide a convincing concretisation of the general legal rules and principles. From the taxpayer's perspective, these guidelines provide safe harbour rules, meaning that if the taxpayer follows the published guidelines, there is no risk of any profit adjustment or assessment of a constructive dividend; on the other hand, where the taxpayer does not comply with the published interest rate guidelines, there will be a rebuttable presumption of a constructive dividend for the 'excessive' portion of the interest paid (similar minimum interest guidelines exist for loans granted to shareholders or persons close to the shareholders). The FAC further reiterated that the notion of 'close person' includes in particular relatives of an individual shareholder, as well as legal entities under the control of the same individual or corporate shareholder(s).

The Court then turned to the nature of PPLs. PPLs can be described as genuine loans in the meaning of Article 312 et seq. Swiss Code of Obligations (CO), which sport the special feature that the lender's compensation for granting the loan capital is made contingent on the borrower's level of profit. Thus, the interest compensation may be variable in full or in part. Typically, the variable portion of the interest reflects a certain participation in the borrower's business profits.

The FAC stressed that, in the proceeding at hand, it remained uncontested that all lenders under the PPLs were either shareholders or persons affiliated with a shareholder. Therefore, the FAC focused on the questions:

- whether the actual interest payments reflected the arm's-length standard in the sense that the benefits exchanged between the borrower and the lenders were proportionate;
- whether the actual amounts of interest paid were rooted in the shareholder participation relation, or the individual lenders' capacity as close persons, respectively; and
- whether the disproportion (if any) was recognisable by the responsible executive organs of the borrowing SwissCo.

With regard to the first question (market conformity of the actually applied interest rate of seven per cent pa), the FTA had pointed to its published interest rate guidelines and determined that those would have provided for significantly lower maximum interest rates for each of the years under review (namely, 2.5 per cent pa for 2010 and 2011, and 3.25 per cent pa for 2012–2014) and stressed that SwissCo would have been able to get cheaper credit in the open market. Further, the FTA had held that its guidelines were applicable to PPLs in the same fashion as to 'normal' interest-bearing shareholder loans, even though the FTA indicated that it would have been prepared in principle to allow for a certain addition to the published safe harbour interest rates if SwissCo had effectively proven a higher arm's-length interest rate for the PPLs based on a market comparison.

The FAC explicitly rejected SwissCo's position that PPLs were not covered by the FTA's arm's-length interest rate guidelines and held that all shareholder loans – whether profit participating or not – are subject to the same arm's-length standard and, accordingly, shall be reviewed in the light of the FTA's interest rate guidelines. The FAC pointed to the general possibility for the taxpayer to prove that, in its specific situation, a higher interest rate than the safe harbour rate pursuant to the FTA's guidelines was in conformity with the market, for example because it made objective economic sense for the borrower to enter into a PPL with a higher risk for the lender compared to a standard loan without any profit participation element. However, it appears from the FAC's considerations that SwissCo had effectively failed to demonstrate to the FTA what rate of interest it would have paid to an unrelated lender, or what rate of interest would have been applied to an independent loan to another borrower in the market in a situation comparable with the SwissCo's. Further, the FAC pointed to the fact that SwissCo effectively enjoyed solid profitability, which substantially reduced the participating lenders' risk of potentially receiving no interest compensation at all.

On that basis, there was no reason for the FTA to grant any addition to its published safe harbour interest rates. Accordingly, the disproportionality of the effectively granted interest benefit was evident (condition one). Fulfilment of condition two – financial benefit favours a shareholder or persons close to a shareholder – remained uncontested.

With regard to the third condition – benefit being rooted in the participation relation, rather than in commercial business reasons – the FAC referred back to its determination that the rate of interest paid by SwissCo was in fact excessive (condition one), further to its assessment that the same amount of interest would not have been paid to an independent third-party lender. Although the latter assessment of the FAC leaves the impression of a somewhat circular conclusion, it should probably be understood in the context that SwissCo had not brought forward any convincing arguments why an independent third party lender should have received a comparable level of interest compensation: SwissCo had only pointed to the fact that the lenders were former equity holders (owners of participation certificates) and the economics of their investment in SwissCo (such as the return) were to be safeguarded upon conversion of the participation certificates into PPLs.

Finally, the Court had to review the fourth condition – whether the disproportion of the level of interest granted was evident for SwissCo's responsible executive organs. The Court pointed to the significant difference between the contractual interest rate of seven per cent pa and the published safe harbour rates, and argued that the executive organs must have known that loans could have been obtained in the market at substantially lower interest rates.

### *Main considerations of the Federal Supreme Court*

Upon the appeal filed by SwissCo against the ruling of the FAC, the FSC first reiterated that taxable investment returns derived from shares issued by Swiss corporate entities in the meaning of Article 4 (1) (b) of the Federal Withholding Tax Act (WHTA), in conjunction with Article 20 (1) of the WHT Ordinance of the Federal Council (WHTO), includes any monetary benefits – such as cash and stock dividends, dividends in kind, liquidation surplus and the like distributed by the company to the holders of participation rights or to persons close to such holders, which do not constitute a repayment of contributed equity existing as of the date of the distribution. The notion of taxable monetary benefits includes so-called constructive dividends. The FSC confirmed the four cumulative criteria for the assessment of a taxable constructive dividend, as already elaborated by the FAC.

As it had remained uncontested that all lenders under the PPLs and recipients of the interest payments in question were to be regarded as shareholders or as persons close to the (single) shareholder of SwissCo, the FSC held that the essential question to be decided upon was whether the excess of the actual interest payments over the applicable safe harbour interest rates pursuant to the FTA's guidelines fulfilled the remaining criteria of constructive dividends. The Court held that, if there was a manifest disproportion between the actual amounts of interest paid and the interest calculated in application of the safe harbour rates, fulfilment of the remaining two criteria – disproportion being rooted in the participation relation and ability of the company's executives to recognise the disproportion – has to be assumed.

Therefore, the key question for the FSC was whether there was in fact a manifest disproportion between the benefit received by SwissCo (ie, the loans) and the benefits granted by SwissCo (ie, the level of interest compensation). The criterion was the market conformity (arm's-length principle). Before the FSC, SwissCo had still argued that, contrary to the findings of the FTA and the FAC, the level of interest agreed under the PPLs was in conformity with the market. SwissCo had pointed again to the fact that the interest due under the PPLs was contingent on SwissCo's profitability, hence the lenders bore the risk that they might not get any interest.

The FSC however confirmed the views expressed by the FAC. A borrower should generally select the financing that offers the best available conditions for it. This does not exclude that a Swiss company might, for specific commercial reasons, agree to enter into a PPL, which might involve a higher interest rate compared with a standard loan. There might even be situations where no other form of debt financing is available. However, such special situations must be demonstrated by the taxpayer. While the FSC did not explicitly mention this reservation, presumably the requirement to justify the entry into a PPL with special business considerations applies only to situations where the PPL is entered into with shareholders or persons close to the shareholders.

The FSC reiterated the FAC's finding that SwissCo had failed throughout the proceeding to specify any valid special circumstances to justify its entry into PPLs with a higher interest compensation. The specific circumstances of the case – in particular the fact that the lenders had previously been equity participants of SwissCo – suggested that the choice of the PPLs and the setting of the high interest rate were driven by the (continuing or previous) shareholder relation, rather than true commercial considerations. Therefore, the FSC confirmed the FAC's conclusion that the FTA had been correct in applying its safe harbour interest rates for standard shareholder loan arrangements.

In further considerations, the FSC rejected arguments raised by SwissCo that the loans had a two-year contractual notice period during which the contractual interest rates could not be changed, and that SwissCo also had bonds outstanding that provided for higher interest rates. However, the FSC confirmed that the FTA's guidelines only provide safe harbour interest rates, which act in the taxpayer's favour if the taxpayer complies therewith; the taxpayer's right to prove effectively higher market interest rates remains expressly reserved.

### *Comments*

The rulings of the FAC and the FSC should be read in the specific factual context of the case, in particular the fact that the PPLs had replaced previous equity investments of the lenders, one lender was SwissCo's parent company, and the other lenders were presumably affiliated with the parent company. Apparently the PPLs were designed to replicate most of the economics of the previous participation certificates. Furthermore, SwissCo had failed to demonstrate sufficient non-tax commercial reasons for the PPL and the level of the interest compensation. Remarkably, the Swiss courts did not per se exclude the possibility of PPLs being at arm's length, even with an interest return higher than the safe harbour interest rates proposed under the FTA's guidelines.

In an *obiter dictum* the FSC briefly touched on the question as to whether the PPLs in the situation at hand might be re-characterised as equity entirely, the consequence of which would have been a complete re-characterisation of all interest paid into dividends for withholding tax purposes. However, as the FTA had accepted the loans as debt and the remuneration as interest up to the level pursuant to the arm's-length interest rate guidelines, the FSC saw no reason to pursue this avenue any further in the matter at hand.

This leaves open the question of whether a PPL entered into by a SwissCo with principally unrelated lenders might lead to dividend withholding tax issues (in conjunction with the non-deductibility of some or even all of the interest charged at the corporate income tax level). In that context it should be noted that Swiss tax laws do not feature any 'interest barrier' or similar tax rules. Swiss income tax codes include a provision to the effect that interest on debt having the economic characteristics of 'hidden equity' is not deductible. For dividend withholding tax purposes, interest paid on 'hidden equity' is qualified as a constructive dividend. The notion of 'hidden equity' is mainly applied in the context of 'excessive' loans provided by the shareholders, or by persons close to the shareholders. To that effect, the FTA has issued another tax guideline (Circular no 6/1997), which defines maximum debt leverage ratios for a number of different asset categories. These 'thin capitalisation' tax rules are principally applicable to debt provided by the shareholders or by persons close to the shareholders, as well as third party debt provided with the support of shareholders or persons close to them. They generally do not apply to independent third-party debt otherwise. Similar to the FTA's arm's-length interest guidelines, the 'thin capitalisation' Circular of the FTA principally provides the taxpayers 'safe harbour' guidance with regard to shareholder debt financing.

That being said, the statutory notion of the 'portion of debt which has the economic meaning of equity (Article 65, Federal Direct Tax Act; Article 24 (1) (c) in conjunction with Article 29a of the Federal Tax Harmonisation Act) could be construed in a somewhat broader sense: i.e., not only referring to debt provided by shareholders or persons close to them. Moreover, for dividend withholding tax purposes, the notion of 'close person' has been construed by jurisprudence of the FSC to include any person receiving non- market-standard monetary benefits from the company based on a corresponding decision by a shareholder.

Against that background, in the author's opinion it cannot be totally excluded that, under certain circumstances, a PPL provided by one or more formally independent third parties might eventually result in taxable constructive dividends – at least with regard to the interest portion exceeding the safe harbour interest rate guidelines, if not the entire interest charged, as the formally ‘independent’ lenders would be qualified as ‘persons close’ to a shareholder. Such might be the case, for example, where the lenders are effectively provided an economic exposure to the borrower that comes close to the profile of an equity investor, which as such is hardly conceivable without the consent of the controlling shareholders. However, to date the author is not aware of any jurisprudence by Swiss courts to such effect.