Reform of the Swiss Federal Withholding Tax on Interest

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For a number of years, endeavors to reform the Swiss federal withholding tax system with regard to the taxation of interest from collective debt instruments have been going on. The reform is generally aimed at strengthening the Swiss debt capital market. The latest proposals would completely do away with federal withholding tax on bond interest.

Background to the reform – the current withholding tax system

Under the current rules, interest paid or accrued on collective debt instruments – so called "bonds" and "debentures" – issued by Swiss resident issuers, as well as interest arising on deposits with Swiss banks is subject to federal withholding tax at the statutory tax rate of 35%. In contrast, interest paid on private and commercial loans, as well as interest paid on collective debt instruments issued by non-Swiss issuers is generally not subject to Swiss federal withholding tax.

Taxable bond and debenture defined

The notions of "bond and "debenture" for federal withholding tax purposes are quite broad. Generally, taxable "collective debt" instruments are defined as written debt acknowledgments for fixed amounts which are issued in multiple tranches at comparable conditions for the purpose of collective financing, and which allow the investor to evidence, reclaim or transfer its receivable claim.

A debt instrument is qualified as a taxable "bond" if it meets all of the following criteria:

- The borrower issues written debt acknowledgments over fixed amounts;
- the debt acknowledgments are based on a single credit arrangement and have identical conditions;
- the lenders include more than ten non-banks (including certain types of sub-participants), i.e. not including Swiss or foreign banks as defined by the Swiss Federal Banking Act or comparable foreign banking legislation at the place of establishment of the lender; and
- the aggregate amount borrowed under the arrangement amounts to at least CHF 500'000.

A loan or similar debt instrument is qualified as a taxable "debenture" for federal withholding tax purposes where the following conditions are all met:

- The borrower issues written debt acknowledgments over fixed amounts;
- the debt acknowledgments may have variable conditions;
- the lenders include more than 20 non-banks (as described above); and
- the total borrowed amount corresponds to at least CHF 500,000.

Taxable Swiss bank deposit defined

Interest paid by Swiss banks as well as Swiss branches of foreign banks acting under a banking license on “customer deposits” is likewise subject to federal withholding tax at the statutory rate of 35%. A taxable “customer deposit” includes debt funds raised by any Swiss resident entity that publicly solicits interest-bearing deposits, or continuously accepts interest-bearing deposits from more than 100 depositors – other than Swiss or foreign banks as defined by the applicable banking legislation – whereby the aggregate amount of the “deposits” amounts to at least CHF 5,000,000.

The federal withholding tax rules exclude Swiss and foreign banks (as described above), as well as any corporate entities under the control or covered by accounting consolidation of the Swiss resident borrower as potentially “harmful” lenders or “depositors that may trigger an interest withholding tax liability for the debt arrangement.

The rather complex definitions of the notions of “bond” and “bank customer deposit” under current withholding tax regulations make it necessary to include fairly restrictive language in syndicated bank loan facilities for Swiss resident borrowers with regard to transfers of any loan portions to “non-bank” investors, to prevent the Swiss borrower from becoming liable for the deduction and payment of interest withholding taxes whenever any of the “non-bank lender” thresholds are exceeded.

Swiss versus non-Swiss issuers/borrowers

Collective debt instruments such as “bonds” or “debentures” as well as “customer deposits” (taking the above-mentioned “non-bank rules” into account) result in a federal interest withholding tax liability where the issuer or borrower is a Swiss resident person or entity. Under certain circumstances, debt formally issued abroad, through a non-Swiss issuer may be deemed to be issued by or on behalf a Swiss resident borrower, and thereby trigger federal interest withholding tax liability. Such will be the case under the following, cumulative conditions:

- The (actual or deemed, see above) bond/debenture is guaranteed by a direct or indirect Swiss parent company of the foreign issuer (down-stream guarantee);
- the proceeds from the issuance of the bond/debenture are directly or indirectly on-lent to one or more Swiss affiliates of the foreign issuer; and
- such on-lending to Swiss affiliates exceeds the sum of (i) the combined accounting equity of all non-Swiss subsidiaries directly or indirectly controlled by the Swiss parent company, plus (ii) the aggregate amount of loans granted by the Swiss parent and its Swiss subsidiaries to its non-Swiss affiliates.

The “debtor system”

Swiss federal withholding tax on dividends and certain types of interest is based on the so-called “debtor system”: The law technically defines the debtor of the taxable payment as the person liable to tax. In particular, where a debt instrument qualifies as a taxable “bond” or “debenture”, the Swiss resident borrower or issuer owes the 35% withholding tax to the Federal Government, irrespective of the nature or fiscal residence of the investor and beneficiary of the interest payment. At the same time, the Withholding Tax Act requires the debtor to shift the economic burden of the withholding tax to the investor, i.e. the beneficiary of the taxable interest payment. Thus, the debtor is legally required to deduct the applicable withholding tax from the taxable gross payment, and to submit such tax to the Federal Tax Administration. Any private arrangements designed to circumvent the debtor’s duty to impose the withholding tax burden upon the income beneficiary are declared null and void by the Withholding Tax Act.

Functions of the federal withholding tax

The function of the federal withholding depends crucially on whether the investor into a taxable equity or debt instrument is a Swiss or foreign resident for tax purposes:

- For Swiss resident investors / income beneficiaries, the federal withholding tax essentially fulfills the function of a mere ”safeguarding” tax, designed to ensure full compliance with the investor’s income tax and net worth tax obligations. Swiss resident individuals and corporate entities beneficiaries may fully reclaim the withholding tax, if they duly report the income in their tax return, or in their accounts used for tax purposes (as applicable) and meet some further conditions, such as beneficial ownership of the income and absence of any tax avoidance. Failure to “spontaneously” declare (or report) the income principally leads to a forfeiture of any withholding tax refund claims.
- For foreign resident investors, the federal withholding tax has a strictly fiscal purpose: Federal withholding tax is principally meant to constitute a final tax burden, with no possibility for a subsequent refund or initial relief at source. Partial or (in some cases) full relief of the federal withholding tax may exclusively be obtained on the basis of international double taxation or similar treaties between Switzerland and the investor’s country of tax residence, to the extent that such treaties limit the authority of Switzerland as a source country to impose withholding taxes.

The 35% federal withholding tax on interest hits all Swiss and foreign resident investors into “collective” debt instruments, including certain types of syndicated loans and revolving debt facilities where the “non-bank rules” are not complied with. This has rendered the issuance of such debt by or through Swiss resident issuers somewhat unattractive, given that the Swiss debtor has to initially deduct the full tax from the taxable interest payment under all circumstances regardless of the nature and tax residence of the investors, without any possibility for a relief at source. Foreign resident investors need to rely on a double tax treaty to obtain any subsequent refund of the withholding tax from the Federal Tax Administration. In the light of these disadvantages, Swiss based groups tend to carry out their collective debt financing activities outside of Switzerland.

Features of the proposed reform

The proposed partial reform of the Federal Withholding Tax Act with regard to interest withholding tax is aimed at mitigating some of the above-described issues. On 3 April 2020, the Swiss Federal Council published a first reform draft with an explanatory report for public comments. The key element of the draft bill was a removal of the “debtor system” (as far as withholding tax on bond interest is concerned) in favor of a “paying agent” system. Under the paying agent system, (Swiss) debtors of collective debt financing instruments would make their interest payments gross, without deduction of any withholding tax. The paying agent (usually a bank in Switzerland) would then have to draw a distinction between different categories of investors/interest beneficiaries:

- Payments/credits of interest to *Swiss resident individuals* would be charged with a 35% backup withholding tax, which the paying agent would deduct and submit to the Federal Tax Administration.
- Payments/credits to any other types of investors, including Swiss corporate investors and any foreign resident investors would be *exempt* from the backup withholding tax.
- The backup withholding tax liability would be extended to interest payments on collective debt instruments (bonds etc.) issued by non-Swiss issuers, where the interest beneficiary is a Swiss resident individual. Furthermore, the backup withholding tax on interest would be extended to any indirect investments in taxable bond instruments made by Swiss resident individuals (typically via investment funds).

Further elements of the draft reform bill inter alia included:

- The backup withholding obligation of Swiss paying agents would also be applicable to interest components in structured financial products;
- A statutory regulation of federal withholding tax on compensation and “replication” payments for taxable dividends and interest (so-called *“manufactured” payments*) would be introduced (at present, such

manufactured payments are only covered by administrative regulations, which in the author's opinion are lacking statutory basis). Swiss paying agents' obligation to apply 35% backup withholding tax to compensation payments for Swiss dividends embedded in the return of derivative financial instruments and structured products, as well as in the context of securities lending and repo arrangements would not only apply to payments made to Swiss resident individuals, but rather to dividend compensations made to all types of Swiss and foreign resident beneficiaries;

- In order to determine the interest components embedded in the returns of Swiss and foreign collective investment schemes (funds), additional detailed reporting requirements would be introduced so as to enable the Swiss paying agent to calculate and deduct proper backup withholding tax in respect of such fund units owned by Swiss resident individuals. As regards foreign investment fund products, a catch-all provision would be introduced to capture the entire return (including underlying Swiss and foreign source dividends and interest, as well as capital gains) as a basis for the backup withholding obligation, unless the foreign fund provides proper reporting to the Swiss paying agent with a breakdown of underlying taxable interest and exempt dividends and gains, respectively;
- Finally, the draft bill provided for an exemption of the trading Swiss bonds from the federal securities transfer stamp duty, which under current law is levied from "Swiss securities dealers" at a tax rate of (up to) 0.15% of the consideration paid for trades in the secondary market.

Results of the consultation process and latest developments of the proposed reform

The public consultation process has shown that, while most commentators have welcomed the general improvements achieved by the proposed change to a paying agent system in conjunction with the limitation of the exposure to (backup) withholding taxes on interest to Swiss resident individuals, especially the banking and investment fund industries have warned against the increased complexities arising from the extension of the backup withholding obligations to non-Swiss debt instruments, and in particular from the extension of such obligations to indirect investments in such (Swiss and foreign) debt instruments.

Considering the overall results of the consultation process, the Swiss Federal Council announced on 11 September 2020 that it would principally go ahead with the withholding tax reform; however, the initially envisaged system of backup withholding on interest arising on Swiss and foreign collective debt instruments (bonds etc.) via paying agents in Switzerland will be dropped in favor of *a full exemption of all interest payments arising on Swiss and foreign issued collective debt instruments to any type of investors*. Only interest paid to Swiss resident individuals on Swiss bank deposits would remain subject to federal withholding tax according to the latest announcement by the Federal Council.

The dispatch to the Federal Parliament with the government's final reform proposal is expected to be issued in the course of the second quarter of 2021. It is expected that the final legislative proposal will still include the abolition of the securities transfer stamp duties on Swiss bonds and similar instruments. To what extent other elements of the initial reform proposal (such as the statutory regulation of the withholding tax treatment of dividend compensations and the like) will be addressed by the final legislative proposal remains to be seen.