SWITZERLAND

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The following article describes certain selected tax aspects of inbound and outbound investments. Although the Swiss tax environment may be considered as very advantageous, there are various rules to be considered in connection with cross-border investments.

INBOUND INVESTMENTS

Overview

In general, the Swiss tax environment for foreign investors investing in Switzerland may be considered advantageous. However, it is important to give due consideration amongst others to the issues of withholding tax on dividend payments and certain interest payments and stamp duties (securities issue tax and securities transfer tax).

The issue of shares in a Swiss corporation is usually subject to 1% securities issue tax (exemptions are available, in particular for merger and merger-like transactions), dividends paid by a Swiss corporation are subject to withholding tax at the standard rate of 35% which is substantially reduced under the broad double taxation treaty network of Switzerland. If a Swiss-registered securities dealer is either party or intermediary to a sale of shares, usually a 0.15% (Swiss shares) or 0.3% (foreign shares) securities transfer tax is levied. However, there is an increasing number of exemptions from securities transfer tax available for certain types of transactions.

Debt instruments are neither subject to Swiss securities issue tax and securities transfer tax nor to Swiss withholding tax as long as they do not qualify as a collective fund raising scheme. Collective fund raising schemes such as bonds (*Obligationen*) and medium-term notes (*Kassenobligationen*) are subject to securities issue tax (bonds: 0.12% of the nominal value for each year of the maximum duration; medium term notes: 0.06% of the nominal value for each year of the maximum duration) if they are issued by a Swiss issuer. Furthermore, securities transfer tax is levied if a Swiss-registered securities dealer is either party or intermediary to a sale of bonds or medium-term notes. There is an increasing number of exemptions available. Interest payments on bonds and medium-term notes are subject to Swiss withholding tax at a standard rate of 35% which is, again, substantially reduced under the broad double taxation treaty network of Switzerland.

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

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

Bonds and medium-term notes

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

- there are more than 10 non-bank lenders;
- the loan amount is at least CHF 500,000 ($300,000); and
- there are identical loan conditions, referring to a single loan agreement only.

Pursuant to the Guideline Regarding Bonds (April 1999) issued by the Swiss Federal Tax Administration, a company creates medium-term notes for the purposes of Swiss withholding tax law and stamp duty law if the following conditions are all met:

- money is borrowed under varying conditions on a continuing basis;
- there are more than 20 non-bank lenders; and
- the total loan amount is at least CHF 500,000.

The conditions for a medium-term note for the purposes of Swiss withholding tax law and Swiss stamp duty law are met if the number of non-bank lenders and of all private placements and single loans of a Swiss borrower exceeds 20.

Therefore, as a rule of thumb, if more than 10 non-bank lenders participate in a loan facility or if the Swiss borrower is financed by more than 20 non-bank lenders, the Swiss tax consequences of a financing structure must be carefully investigated.

Structures involving foreign vehicles

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

- the funds are raised by a foreign vehicle (special purpose vehicle or SPV) which has one single purpose, namely to issue one bond and to transfer the funds to a Swiss company; or

- the funds are raised by a foreign subsidiary of a Swiss company and the bond is guaranteed by the Swiss parent company. Swiss tax authorities do not accept such a structure, unless the funds raised are used abroad.

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

Securitization

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

- the transfer of the assets to the SPV must be at arm's length, ie, a true sale;

- the assets transferred must be eliminated from the financial statements of the originator and must be replaced by the sales price;

- the risk for the assets, in particular the bad-debt risk, must be fully borne by the SPV; and

- no obligation exists on the part of the originator to take back the assets.

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

In cases where the receivables transferred from the originator to the SPV are neither tax-exempt nor zero-rated, the Swiss VAT treatment of the transaction must be carefully investigated.

Thin capitalization rules

Under Circular Letter No 6, the determination of the maximum debt level is a three-step procedure. Firstly, it must be determined whether there is any qualifying debt. Only debt owed to shareholders or other related parties may be reclassified as (hidden) equity. Debt owed to independent third parties is not considered as hidden equity as long as this debt is not guaranteed in any way by related parties.

Secondly, the amount of admissible debt has to be calculated based on the calculation method set out in the Circular Letter. For companies other than finance companies, the maximum debt level is determined as a percentage of the fair market value of the company's assets (see figure 1).

If, as a result of steps one and two, the financing does not meet the safe haven rules, the company is still entitled to prove that, due to specific circumstances, the financing complies with the arm's length principle and that a reclassification is not appropriate.

In summary, the following requirements must be cumulatively met in order to qualify as a company with thin capitalization:

- the loans are granted and/or guaranteed by shareholders or other related persons;
- the debt level exceeds the maximum debt amount as calculated on the basis of the percentage stated in Circular Letter No 6; and

Figure 1

Maximum debt level of company's assets

Assets	Maximum debt financing (%)
cash	100
receivables	85
inventories	85
other current assets	85
bonds	80-90
securities	50-60
participations	70
loans	85
office equipment	50
immovable property	70-80
incorporation and organisation expenses	0
other intangibles	70

For finance companies, the maximum debt level is calculated based on the traditional debt:equity ratio of 6:1

- the debt level does not comply with the arm's length principle.

OUTBOUND INVESTMENTS

Overview

The Swiss tax consequences for the various categories of Swiss investors investing abroad may be summarized as follows:

Swiss resident individual investors: Capital gains on the sale of shares in a foreign company are usually tax-free in Switzerland. Moreover, capital gains derived from the sale of bond instruments are also tax-free, if the instruments do not represent so-called bonds with predominant one-off interest payments, eg, discount bonds. Dividends and interest paid by foreign companies are subject to personal income tax at ordinary rates. Income derived from derivative products is usually split into a (non-taxable) capital gains/option portion and a (taxable) income portion. Special rules apply to Swiss resident individuals holding their investments as business assets or individuals considered as professional securities dealers.

Swiss resident corporate investors: Generally speaking, any profit derived from the investment in an equity or debt instrument is subject to ordinary corporate income tax. A tax-exemption is available on dividends and capital gains derived from qualifying participations. If a Swiss-resident corporate investor holds a participation in the dividend-paying company of at least 20% or a fair market value of at least CHF 2 million, the dividends are subject to the participation exemption. If a Swiss-resident corporate investor sells at least a 20%-stake in a Swiss or foreign company which has been held for at least one year, the capital gain is also subject to the participation exemption.

Special rules apply to institutional investors such as pension schemes (usually fully tax-exempt) and holding companies (usually tax-exempt for cantonal and communal corporate income tax purposes).

Derivative products

On April 12 1999 the Swiss Federal Tax Administration issued Circular Letter No 4 Regarding Bonds, Notes and Derivative Financial Instruments and Their Treatment Under Direct Federal Tax, Withholding Tax and Stamp Duty. This Circular Letter contains taxation principles regarding derivative products and tries to determine under what circumstances a product must be treated as either a taxable bond instrument or non-taxable option. For a Swiss-resident individual investor, a taxable bond instrument issued by a non-Swiss issuer leads to income tax consequences on the interest portion as well as to Swiss securities transfer taxes in cases where a Swiss-registered securities dealer is either party or intermediary to a sales transaction.

For Swiss-resident corporate investors or individual investors considered as professional securities dealers or individual investors holding the derivative product as a business asset, the qualification is, from an income tax point of view, not of further importance since any profit derived from the product is taxable anyway.

Generally speaking, Circular Letter No 4 takes an economic approach and analyses the economic content of a derivative product. If a financial product is considered as a mixed product, containing non-taxable options and taxable bond elements, the income derived from it may be split into a non-taxable and a taxable portion provided that the two portions are traded separately or that the issuer of such product publishes the different components in the sales documentation and in the prospectus (transparency requirement).

Partnerships

In Switzerland there are no generally accepted rules regarding the taxation of Swiss-resident investors in foreign investment partnerships. Since the taxation of Swiss-resident investors is based on the direct federal tax law on one hand and the cantonal and communal tax laws of the 26 cantons on the other hand, the tax treatment of Swiss-resident limited partners of a foreign investment partnership may differ from canton to canton. It is therefore strongly advisable to carefully investigate each case and to seek advance ruling discussions with the responsible Swiss tax authorities.

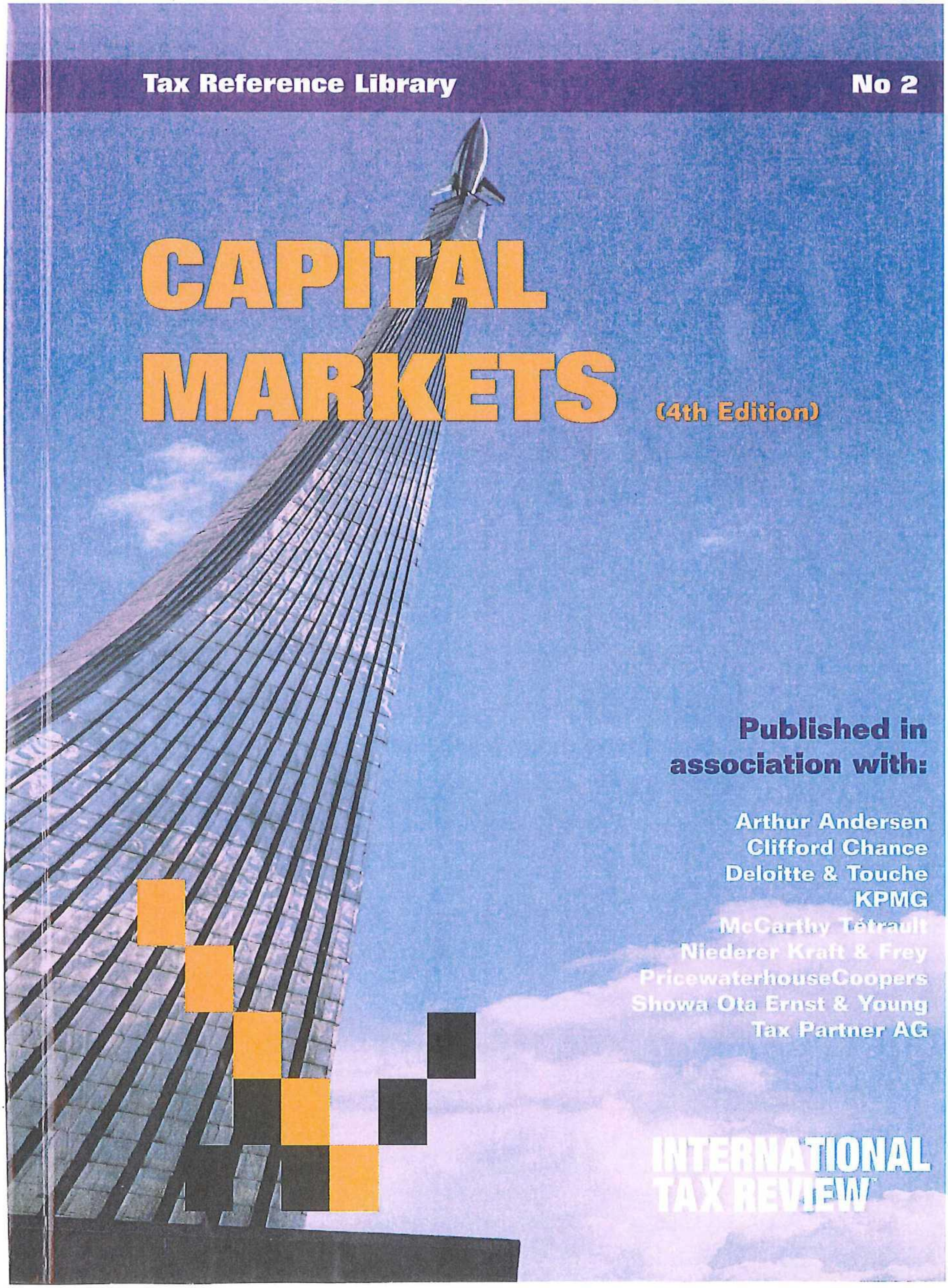
Institutional investors: Swiss tax-exempt institutional investors such as pension funds are not subject to Swiss income tax on capital gains and other income derived from the investment partnership. Capital gains and other income derived from the investment partnership do benefit from tax-exemption for Swiss tax purposes. Swiss-resident institutional investors which are not tax-exempt are taxed according to the rules for corporate investors as described below.

Corporate investors: It could be argued that a Swiss corporate investor investing as limited partner in a foreign investment partnership constitutes a foreign permanent establishment pursuant to article 52 paragraph 1 of the direct federal tax law. Whether Swiss tax authorities would accept such an argument depends on the entrepreneurial engagement of the Swiss investor and on the foreign substance of the investment partnership. If the partnership share of a Swiss-resident limited partner were treated as a foreign permanent establishment, capital gains and other income derived from the partnership would not be subject to Swiss taxation to the extent that the income would be allocated to the foreign permanent establishment.

The same argument can be used for Swiss-resident individual investors holding the partnership share as part of their business assets, such as partnerships and limited partnerships (*Kollektiv- und Kommanditgesellschaften*) and single enterprises (*Einzelunternehmen*).

Individual investors: For Swiss-resident individual investors it is questionable whether the Swiss taxation principles for business partnerships (*kaufmännische Personengesellschaften*) or non-business partnerships (*nicht-kaufmännische*

Personengesellschaften) do apply. If the taxation principles for business partnerships were applied, there is the additional question of whether Swiss tax authorities would accept a foreign permanent establishment/place of business or not. If the taxation principles for non-business partnerships were applied, the investment partnership would be treated as transparent for Swiss tax purposes. Capital gains derived from the investment partnership would therefore represent tax-free private capital gains as long as the Swiss-resident individual investor does not qualify as a professional securities dealer. Other income derived from the investment partnership would usually be subject to Swiss personal income tax at ordinary rates. The qualification as a business or non-business partnership may depend on the entrepreneurial engagement of the Swiss-resident investor and the organisation structure of the partnership. If the investment was considered an investment in a business partnership, Swiss-resident investors would not be subject to Swiss income taxes on their capital gains and other income derived from the investment partnership to the extent that the income could be allocated to a foreign permanent establishment/place of business.



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(4th Edition)

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