Making the most of new thin capitalisation rules

Swiss tax expert Dr Thomas Graf of Niederer Kraft & Frey explains the new tax measures and says that they leave scope for interpretation and negotiation.

A common way to optimise the overall tax position of a group is to finance high-tax entities with intra-group loans granted by low-tax entities since interest paid on such loans can usually be deducted from taxable income.

Under various jurisdictions, this tax-planning technique is limited by so-called thin capitalisation rules declaring maximum debt levels for companies. The Swiss federal tax administration has recently issued new guidelines regarding maximum debt levels for Swiss companies. The new guidelines are applied for direct federal tax as well as for Swiss withholding tax purposes. For cantonal and communal tax purposes, and for treaty shopping purposes, different rules may be applicable.

Overview on Swiss thin capitalisation rules

Direct federal taxes – new safe haven rules

Article 75 of the direct federal tax law (DFTL) states that excessive debt of corporations has to be treated as equity. The DFTL imposes an economic justification test in order to determine whether debt financing is excessive or not in a legal sense. The DFTL neither includes further details on the economic justification test nor declares a specific debt:equity ratio.

On 6 June 1997, the federal tax administration issued the circular letter No 6 on hidden equity of corporations and cooperatives. This included safe haven rules on debt financing and has replaced the old safe haven rule (debt:equity ratio of 6:1).

The letter has no legislative power but represents – in a strict interpretation – the internal guidelines of the federal tax administration only. As yet, there has been no court case accepting the guidelines as a generally applicable standard. However, since the assessment practice of the federal tax administration usually strictly follows the guidelines, it is advisable to comply with the principles or to negotiate any deviation in advance.

Swiss withholding taxes

The federal tax administration has announced that the rules of the circular letter No 6 are also applicable for Swiss withholding tax purposes.

According to Swiss unilateral law, intra-group interest is usually not subject to Swiss withholding tax. However, interest on loans which are considered as hidden equity is reclassified as constructive dividend payments and therefore subject to a 35% Swiss withholding tax. For the determination of the hidden equity for withholding tax purposes, the circular letter No 6 will now be applied as well.

Swiss anti-abuse decree of 1962 (anti-treaty-shopping provisions)

On 14 December, 1962, the Swiss federal government enacted a decree introducing unilateral measures against the abuse of double taxation treaties concluded by Switzerland (Swiss anti-abuse decree of 1962). The decree represents the basis of the Swiss anti-treaty shopping legislation. Its provisions are also explicitly included in the double taxation treaties which Switzerland has concluded with Germany, France, Italy and Belgium.

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The provisions of the anti-abuse decree apply to all Swiss companies which claim relief from foreign withholding taxes on dividend, interest and royalty payments based on a Swiss double taxation treaty. The treaty benefits are denied to those companies which do not comply with the rules of the anti-abuse decree. *Inter alia*, the decree does not accept an 'unusual' financing of a company and provides, therefore, for a debt:equity ratio of 6:1.

This ratio, as set forth by the Swiss anti-abuse decree, must not be understood as a safe haven, but as a requirement to be strictly met. For treaty protection purposes, the application of the 6:1 ratio is not waived even if the company meets a test of 'dealing at arm's length'. The 6:1 debt:equity ratio also applies in the case of foreign-controlled Swiss companies claiming refund of Swiss withholding tax on dividend and interest payments.

Swiss cantonal and communal taxes

The thin capitalisation rules relating to direct federal tax do not apply to cantonal and communal taxes.

There is still a wide variety of debt:equity rules in the swiss cantons, despite the establishment of the federal law on harmonisation of the direct taxes of the cantons and communes of 14 December 1990.

Most Swiss cantons do not have strict debt:equity rules but decide on a case-by-case basis whether the debt level of a company meets the 'dealing at arm's length' principle. A minority of the cantonal tax laws includes concrete debt: equity provisions (the Zug tax law provides for a 4:1 ratio for real estate companies and for a 6:1 ratio for other companies).

By contrast with the direct federal tax situation, where a proportional income tax rate of 8.5% is applied, cantonal and communal tax rates are usually progressive and depend on the company's return on equity (ratio between taxable profit and taxable equity). The higher the return on equity, the higher the tax rate. Hidden equity as a result of a loan reclassification creates additional taxable equity and may, therefore, lead to a decrease in the company's cantonal and communal tax rate. Because of this, cantonal tax authorities are sometimes reluctant to attack a company's financing arrangements.

New safe haven rules for direct federal taxes and withholding taxes

Under the circular letter No 6, the determination of the maximum debt level is a three-step procedure:

1. 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.
2. The amount of admissible debt has to be based on the calculation method of 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)*.
3. 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 'dealing at arm's length' principle and that a reclassification is not appropriate.

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

- 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 percentages stated by the circular letter No 6; and
- the debt level does not comply with the 'dealing at arm's length' principle.

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

Tax effect of hidden equity

Direct federal taxes

As a primary consequence of a reclassification of loans as hidden equity, the related interest payments are not tax-deductible for income tax purposes. Such interest payments are considered as constructive dividends.

In the case of non-interest bearing or low-interest intra-group loans, the amount of reclassified interest is lower than the total interest amount effectively paid on hidden equity. The reclassification of interest expenses is limited to that portion of total interest which would be reclassified if the maximum interest rate allowed by the federal tax administration (as from 1 January 1998, 6% for business loans in Swiss francs) were applied to the loan portion which is not considered as hidden equity.

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On the direct federal tax level, capital tax has been abolished as from 1 January 1998.

Cantonal and communal taxes

On the cantonal and communal tax level, the same basic consequences arise as on the direct federal tax level. Interest on hidden equity is not tax-deductible. However, because of the progressive character of cantonal and communal tax rates, hidden equity may lead to a decrease in the income tax rate as well.

Furthermore, hidden equity increases the tax basis of the cantonal and communal capital tax which is levied based on the company's share capital plus reserves plus hidden equity.

Withholding taxes

Interest payments on loans reclassified as hidden equity are considered as constructive dividends and are subject to Swiss withholding tax at the standard rate of 35%. Swiss recipients of such constructive dividends are usually entitled to a full refund of the withholding tax (which may not be levied at all if the declaration procedure is not applicable), while foreign recipients may partially or fully reclaim the withholding tax on the basis of the Swiss double taxation treaty applicable.

Summary

Compared with the thin capitalisation rules of other European countries, the Swiss rules seem to be reasonable and rather liberal. The 'dealing at arm's length' test as set forth by the circular letter No 6, the cantonal and communal legislation and the traditional and extensive ruling practice of the Swiss tax authorities leave considerable scope for interpretation and negotiation in each case.

It is, therefore, advisable to investigate the capitalisation of a Swiss company in detail in order to optimise its tax position. In difficult cases, an advance ruling must be obtained from the tax authorities. ■

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