D. Schmucki Fricker and M. Kronauer*

Tax Treatment of the Resident Issuer and Resident Contingent Convertible Bond Holders

1. Introduction

On 20 April 2011, the Federal Council of Switzerland proposed an amendment to the Swiss Banking Act concerning "too big to fail" banks (TBTF Proposal). This proposed legislation is currently being discussed in the Swiss parliament. The outcome and the entry into force is not yet clear.

The TBTF Proposal also foresees changes in Swiss stamp duty legislation in relation to contingent convertible bonds (CoCos) as described in this survey. Additional changes regarding the Swiss withholding tax system will be proposed later in 2011. This article will describe the proposed and announced changes based on the current proposal and the announcement of the Swiss government, which are collectively referred to as the TBTF Proposal.

It is currently not clear the extent to which CoCos issued by Swiss banks will be fully in compliance with the features as described in this survey.

2. The Issuer

2.1. Treatment of bonds prior to conversion as debt or equity for tax purposes

Under current Swiss tax law, such bonds will usually be treated as debt (and not equity) for tax purposes. As a matter of principle, the tax authorities rely on the booking in the statutory accounts. If the bonds are accounted for as debt, they will be treated as debt also for Swiss tax purposes even if the bonds qualify as capital from a regulatory perspective. As a result, the taxable equity of banks is often much lower than their capital for regulatory purposes.

This should not change under the TBTF Proposal; however no final comment is possible at this point because the competent authorities have not yet reviewed the specific nature of CoCos under the TBTF Proposal.

2.2. Criteria for equity characterization

Not applicable.

2.3. Tax deductibility of interest paid on the bonds

As a rule, interest paid to third parties on such bonds is deductible for Swiss corporate tax purposes (including any premium reflected in such interest rate). In third-party relationships, thin capitalization regulations do not apply.

If the bonds are granted by shareholders (owners) only, it may be that the generally applicable thin capitalization rules would have to be followed.

This should not change under the TBTF Proposal. However, again, no final comment is possible at this point because the competent authorities have not yet reviewed the specific nature of CoCos under the TBTF Proposal.

2.4. Deductibility on an accrual basis for any deferred interest

As a rule, the treatment of interest payments for Swiss tax purposes follows statutory accounting. Provided that provisions for deferred interest are accounted for properly and are commercially justified, deferred interest is deductible on the basis of the accruals. The fact that payment of deferred interest may be in the form of the alternative coupon satisfaction mechanism (ACSM) does not have any impact on this treatment.

This should not change under the TBTF Proposal. However, no final comment is possible at this point because the competent authorities have not yet reviewed the specific nature of CoCos under the TBTF Proposal.

2.5. Potential adverse consequences from conversion

Upon conversion of the bonds into share capital, the conversion will be subject to Swiss securities issuance tax at the rate of 1%. Such tax must be borne by the issuer. Apart from that, no adverse tax consequences will be triggered.

Under the TBTF Proposal, no Swiss securities issuance tax should become due on the conversion of qualifying CoCos of systemically relevant Swiss banks.

2.6. Withholding tax on payments on the bonds

Under current Swiss tax law, interest payments under the bonds will be subject to Swiss withholding tax at the rate of 35%, as bonds in general. The issuer is responsible for deducting and remitting this withholding tax to the Federal Tax Administration. The bond holders may be entitled to a refund because (1) they are Swiss resident individuals or entities and meet the necessary requirements (proper accounting/declaration, no tax avoidance) or (2) because an applicable income tax treaty provides for a full or partial refund and the specific requirements of that treaty are met by the bond holder. No reduction at

* Niederer Kraft & Frey AG, Zurich.

source procedure is available with regard to withholding tax for interest payments.

If the TBTF Proposal enters into force, there will be two major changes to the Swiss withholding tax system. It will no longer be the issuer who is responsible for deducting and remitting the Swiss withholding tax to the Swiss tax authorities, but any Swiss resident paying agent within the meaning of the TBTF Proposal. In addition, no Swiss withholding tax will become due if interest payments are made to an address in a country with which Switzerland has entered into an income tax treaty or if the interest payments are made to Swiss resident legal entities.

2.7. Indirect taxes, stamp duties, capital taxes or similar taxes upon issue, transfers and/or conversion of the bonds

Upon issue of the bonds, securities issuance tax at a rate of 0.12% per each year of the term of the bond will become due, calculated on the nominal value. Under the TBTF Proposal, Swiss securities issuance tax will no longer become due.

Upon transfer of the bonds, securities transfer tax at a rate of up to 0.15% may become due if a Swiss registered securities dealer is involved as a party or an intermediary in the transaction. Banks and regulated financial institutions usually qualify as Swiss registered securities dealers for securities transfer tax purposes. No significant other taxes should become due.

Upon conversion of the bonds into share capital, the conversion will be subject to securities issuance tax at the rate of 1%. Such tax must be borne by the issuer. Under the TBTF Proposal, no Swiss securities issuance tax will become due upon conversion of qualifying CoCos for systemically relevant Swiss banks.

3. The Bond Holders

3.1. Relevance of characterization of bonds as debt or equity for tax treatment of interest in hands of bond holders

Interest payments (derived from debt) and dividend payments (derived from equity) are not taxed in the same way. Interest in the hands of the Swiss resident bond holders will, as a matter of principle, be ordinarily taxed. Dividend payments may benefit from a preferential income or profit tax treatment. It is, however, without published precedent that a Swiss issued instrument with no participation of the bond holder in specific form of capital (e.g. share capital, participation capital) is treated as equity for Swiss tax purposes.

3.2. Tax deductibility to bond holders of any loss upon conversion

Such losses should be tax deductible for Swiss resident corporate bond holders. For such bond holders, taxation usually follows the accounting regardless of whether the loss arises before conversion, upon conversion or upon a subsequent sale of the shares obtained. However, for Swiss resident individual bond holders, losses (as well as gains) from bonds with periodic interest payments (as opposed to predominant one-time interest payments) are in general not taken into account (as long as held as private assets).