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**A: Interest deductibility:
the implementation of
BEPS Action 4**



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Summary and conclusions

Switzerland has known thin capitalisation rules for more than 20 years. The goal of these rules is not only to prohibit base erosion and profit shifting but also to protect the economic double taxation in case of equity investments. One consequence of such *ratio legis* is that these rules do not only limit interest payments, but a reclassification applies as excessive interests are considered to be dividends for tax purposes (i.e. for corporate income tax, individual income tax and withholding tax purposes). Interestingly, the calculation of the excessive interest payments follows an asset/debt ratio as a safe haven for the taxpayer. This means that if the taxpayer can prove that its financing structure is in compliance with published asset/debt ratios, excessive interest payments do in general not occur. One problem of the Swiss practice which is highlighted in the report is that the asset/debt ratios are not in line with the legal wording of the Swiss thin capitalisation rules. The relevant articles would require a functional analysis of a financing instrument as the law requires that a reclassification is only possible if a debt instrument is considered to be equity from a substance over form perspective. However, the current practice is protected by case law of the Swiss Federal Supreme Court and it has been approved that the asset/debt ratios are in line with the law. Nevertheless, the authors see a need to change either the current practice or the current wording of the law in order to achieve compliance.

Interest limitations rules such as those proposed in Action 4 of the BEPS project or contained in the ATAD have not been intensively discussed in Switzerland and as far as it can be observed there is no intention by the legislator to change the current rules and to implement a rule in line with these international developments. Moreover, the current laws do not contain specific rules addressing potential double taxation due to the application of interest limitation rules in the jurisdiction of the borrower.

Part One: General rules on interest deductibility

1.1. General overview

Interests are in general deductible in Switzerland at the level of the borrower if the borrower is either a corporate entity or if the loan is allocated to the business of an individual. If a loan is part of the private wealth of an individual, i.e. not related to his or her business activities, interest deductions are limited to the income from movable and immovable assets plus CHF

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50'000.³ The focus of the present branch report should, however, be on the corporate income tax treatment of interests.

The calculation of the corporate income tax base in general follows accounting law (principle of determinance or authoritative principle; *Massgeblichkeitsprinzip*).⁴ Interests are considered to be business expenses for accounting purposes and are, therefore, deductible for corporate income tax purposes. Interest deduction applies in all circumstances be it on profit-participating loans, subordinated loans or convertible loans.⁵ Moreover, interests-in-kind would also be a deductible expense. It is in general not disputed whether interests are business expenses; the crucial question is, however, to what extent interest payments are considered to be excessive.

Moreover, it does not matter whether the recipient is a domestic or a foreign corporation. It does also not depend on the tax status of the recipient, i.e. whether the recipient is an ordinary taxed company or whether he applies a specific tax regime. Even if the recipient is not taxed on the interests received, the Swiss borrower has access to the interest deduction.⁶

Some further particularities should be highlighted as introductory remarks: First of all, a deduction also applies if there are timing differences. For instance, in Switzerland accrued interests are deductible even though these interests are not yet included in the tax base in the jurisdiction of the lender. Therefore, and this is the second important remark, there are no linking rules in place applying at the level of the borrower. Interests are deductible even if they are not included in the tax base of the lender in the receiving state. Switzerland has also not intended to implement linking rules disallowing deductions. Thirdly, following the principle of determinance, the interests have to be reflected in the profit and loss statement. Therefore, a mere deduction for tax purposes is not possible in Switzerland.⁷

1.2. Definition of “interest”

1.2.1. In general

There is no detailed definition of the term interest for Swiss income and corporate income purposes. However, at least for corporate income purposes the distinction between interest and dividend payments is rather straight-forward. Interest payments are based on a loan agreement (i.e. a civil law contract) whereas dividends are paid on a corporate right (i.e. a right created by a corporate decision).⁸ Corporate rights are, inter alia, shares, participation rights and jouissance rights (“Genusscheine”). The distinction is, therefore, a formal one;

³ Art. 33 (1) (a) Federal Act on Direct Federal Tax (**FDTA**), Art. 9 (2) (a) Federal Act on the Harmonisation of Direct Cantonal and Communal Taxes (**FHTA**).

⁴ Art. 58 FDFA, art. 24 FHTA.

⁵ See already Th. Meister, Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions, *Cahiers de droit fiscal international* 2001, p. 613 et seq. For further details about the distinction between debt and equity from a tax perspective P. Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz*, Zurich 2012, p. 51 et seq.

⁶ However, structures leading to a deduction/no inclusion result would more likely be challenged by the application of the Swiss GAAR.

⁷ See, however, s. 1.2.3.

⁸ For further details see P. Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz*, Zurich 2012, p. 51 et seq.

at least for corporate income tax purposes no substance over form analysis applies.⁹ This means that even interest payments on mandatory convertible bonds, on convertible bonds, on contingent convertible bonds, i.e. on bonds with several equity features, are deductible for corporate income tax purposes. Therefore, even interest payments on financing instruments close to equity from a substance over form perspective, are deductible.

1.2.2. *Bifurcation approach*

For income tax and withholding tax purposes, a substance over form distinction is made concerning the treatment of income from structured products.¹⁰ This means that the income from structured products is split into an interest component (i.e. a market rate) and capital gains component. Switzerland applies, therefore, a bifurcation approach. In other words, and to be more precise, on certain structured products, the coupon payment to the investor is split into an interest component subject to income tax and a capital gain component tax free for private investors. The taxable interest component is a market interest rate, i.e. either the Swap rate or Libor rate (the latter for terms of less than 12 months) in the currency of the structured product. As indicated already such an interest definition is mainly related to structured products which do not have the goal to substantially finance the issuer.¹¹ Therefore, such a bifurcation approach in general does not apply with respect to traditional financing instruments. However, it has also been applied in a few cases of certain financing instruments such as mandatory convertible bonds or contingent convertible bonds.¹² In these cases the interest payments could also be split into a taxable interest component (i.e. a market rate) and a tax-free capital gain component. However, such a bifurcation approach can only be applied by issuers having a single A rating. Therefore, in case the issuer has no rating such as an SME or a lower rating than single A, the entire payment is qualified as an interest. Importantly, such a bifurcation approach also applies for withholding tax purposes, for example if the issuer is a Swiss entity, the coupon payments on these structured products can be split into an interest component subject to withholding tax and a withholding tax free capital gain component. In conclusion, in case the bifurcation approach applies, the term interest is understood with reference to market rates.

1.2.3. *Treaty definition*

Related to the domestic definition of interests is the question of what is an interest for treaty purposes. In particular the difference between the domestic understanding of interests and the understanding according to article 11 (3) OECD MC or the relevant tax treaties signed by Switzerland, is of relevance. However, Swiss courts are in general reluctant to apply autonomous treaty interpretations. The same is true for tax authorities. It seems, therefore,

⁹ See, however, the bifurcation approach applicable for income tax purposes outlined in s. 1.2.2.

¹⁰ See SFTA Circular Letter No. 15, Taxation of Bonds, Derivative Financial Instrument for Federal Direct Tax, Withholding Tax and Stamp Duty Purposes, 3 October 2017.

¹¹ The funds raised from the sale of structured products are in general used to hedge the underlying and not to invest these funds into the operating business of the issuer.

¹² See e.g. the Contingent Convertible Notes issued by Credit Suisse Group AG (<https://www.credit-suisse.com/media/assets/corporate/docs/about-us/investor-relations/regulatory-disclosures/t1-ch0352765157.pdf>).

that the Swiss authorities assume to qualify an income as an interest for treaty purpose, i.e. applying article 11 of the respective double tax treaty, if it is an interest for domestic tax purposes.¹³ Therefore, courts and tax authorities would apply the same understanding of the term interest both for domestic tax law purposes and for the application of article 11 of the OECD MC and the respective treaty provision. There is however no explicit case law available regarding the differences between the domestic understanding of interests and the treaty definition.¹⁴

1.2.4. *Deemed interest payments*

As will be outlined in the following, there are guidelines available regarding the applicable arm's length interest rate (so-called **safe haven rules**). These rules regarding the interest deductibility have not changed following the BEPS Action 4 report. However, as part of the corporate tax reform III an introduction of a notional interest deduction was discussed and proposed. The final version of the reform act contains in article 25a^{bis} FHTA a provision granting the Cantons the right to introduce a deemed interest deduction. However, such deemed interest deduction is only granted on the excessive equity and it may enable a reduction of the effective tax rates to a level not lower than 13.5%. Moreover, the Swiss finance branch regime allowed certain deemed interest deductions. Such regime has been challenged by the OECD as being harmful. Due to international pressure, the Swiss finance branch regime will likely be abolished by 1 January 2020.

2. Review of anti-avoidance regime before the BEPS Action 4 report

2.1. Limitations that re-characterise interest as non-deductible distributions

2.1.1. *Overview*

Switzerland has no specific anti-avoidance tax act. However, Switzerland knows an unwritten GAAR which was developed by the Swiss Federal Supreme Court as a judicial practice in the 1930s.¹⁵ Moreover, there are a few written specific anti-avoidance rules (SAARs) that apply to defined fact patterns.¹⁶ One SAAR, which will be the focus of the following analysis, restricts the interest deductibility in financing situations with related parties (so called **thin capitalisation rules**). The following sections outline the main elements of these thin capitalisation rules and its related tax practice.

¹³ See e.g. M. Weidmann, in: Kommentar zum internationalen Steuerrecht, Basel 2015, art. 11 § 3 et seq.

¹⁴ See for a detailed review of the term interest in double tax treaties of Switzerland P. Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz*, Zurich 2012, p. 252 et seq.

¹⁵ See e.g. N. Kunz-Schenk, *Swiss Branch report, Anti-Avoidance Measures of General Nature and Scope – GAAR and other Rules*, Cahiers de droit fiscal international 2018, p. 5 et seq.

¹⁶ See, for instance, art. 20a FDTA tackling structures in which tax payers intend to transform taxable dividends into tax free capital gains.

For the following analysis it is crucial to understand that the tax treatment of debt and equity, as in most other states, differs in various aspects in Switzerland. Debt financing seems in general to be more beneficial than equity financing due to various reasons, being the economic double taxation of equity funding through corporate income- and individual income taxes as well as through individual wealth- and the corporate capital taxes. The latter is a tax on the net equity of a corporation.¹⁷ In addition, the injection of equity as capital is in general subject to the one-time stamp duty (1%)¹⁸ and dividends are subject to the withholding tax (35%).¹⁹ In contrast, the interest expense on debt funding is generally a tax deductible expense.²⁰ Furthermore, neither a capital tax on debt capital nor the one-time stamp duty (1%) on the injection of debt is levied. Finally, interest expenses are generally not subject to withholding tax, unless the financing would qualify as bond or debenture.²¹ In conclusion and as in other states there are good tax reasons for debt funding of a Swiss company instead of an equity funding. It is, therefore, not surprising that Switzerland has introduced rules limiting interest payments. These thin capitalisation rules are the focus of the following sections.

2.1.2. *The Swiss thin capitalisation rules*

The Swiss concept of thin capitalisation has at least three fundamental goals: (i) securing the mentioned economic double taxation which includes the prevention of misusing the financing freedom, and (ii) equal treatment of all profitable entities and (iii) the limitation of base erosion and profit shifting through interest deductions in cross-border or intercantonal circumstances. The wording of the respective provision is the following:

“The taxable income of corporations and cooperatives includes those parts of interests on debt which belong to debt capital but have the economic substance of equity capital.”

The legal base is found in article 65 FDTA for federal corporate income tax purposes as well as in article 24 (1) (c) in conjunction with article 29a FHTA for cantonal corporate income tax and cantonal equity capital tax purposes. The FHTA aims at harmonising corporate income tax laws at a cantonal level at least with respect to the calculation of the tax base.²² Moreover, with very few adaptations, such a provision is also found in all cantonal income tax laws. These mentioned articles entered into force on 1 January 1998 and were essentially not amended since then. In the following we will outline the practice of the tax authorities concerning the application of the thin capitalisation rules.

¹⁷ See art. 29 FHTA.

¹⁸ See art. 5 Stamp Duty Act (SDA).

¹⁹ See art. 4 Withholding Tax Act (WTA).

²⁰ See art. 58 (1) FDFT, art. 24 (1) FHTA.

²¹ A bond is a debt financing which is publicly sold at least offered to more than 10 non-banks at identical terms or 20 non-banks at differing terms (see SFTA Leaflet Bonds, April 1999).

²² See art. 129 of the Federal Constitution.

2.1.3. SFTA's safe haven approach

In order to achieve legal certainty, the Swiss Federal Tax Administration (SFTA) has published safe haven rules protecting the tax payer from the application of the Swiss thin capitalisation rules. The goal of such practice is to calculate the maximum amount of debt to be obtained from related parties and the interest capacity of a company. In order to do so, as a starting point, the balance sheet of each tax payer is decisive. Already in June 1997, even before the legal base entered into force, the SFTA issued a Circular Letter No. 6 (Circular Letter 6/1997) for the purpose of specification, delimitation issues and unification of the Swiss wide practice around the thin capitalisation issue as it comes to Federal Corporate Taxes assessed by the Cantons. The Circular Letter 6/1997 should give an indication to the tax payer of the average debt capital available on the “free financing market”.²³ In order to do so, it contains certain asset/debt ratios. The link to the assets in the balance sheet should be a helpful method for the taxpayer and the tax administration to determine the usual amount of debt funds receivable from third parties. Therefore, the tax payer and the tax administration should be able to evaluate in a first step whether a detailed examination of the substance of a debt investment is necessary or the debt funding is in line with the safe haven rules.

According to the Circular Letter 6/1997 the maximum debt allowed ‘for finance companies’ is 6/7 of the total assets (fair market value).²⁴ For other companies, the maximum debt allowed is defined for certain types of assets (also valued at their fair market values) as follows:²⁵

- cash: 100%;
- accounts receivable: 85%;
- inventory: 85%;
- other current assets: 85%;
- bonds in CHF: 90%;
- bonds in foreign currency: 80%;
- quoted shares: 60%;
- non-quoted shares: 50%;
- investments in subsidiaries: 70%;
- loans: 85%;
- furniture and equipment: 50%;
- property, plant (commercially used): 70%;
- other real estate: 80%; and
- intellectual property rights: 70%.

The debt ratio to the types of assets that are not on the aforementioned list must be identified by means of a debt capacity analysis²⁶ and/or otherwise agreed upon with the tax administration.²⁷ The Circular Letter 6/1997 is an administrative regulation and therefore in general binding for assessment authorities.²⁸ As long as the relevant taxpayer is acting

²³ See R. Böhi, *Das verdeckte Eigenkapital im Steuerrecht*, Zurich 2014, p. 215.

²⁴ Circular Letter 6/1997, p. 2.

²⁵ See Circular Letter 6/1997, p. 2.

²⁶ See below 2.1.4.

²⁷ See R. Böhi, *Das verdeckte Eigenkapital im Steuerrecht*, p. 261 et seq.

²⁸ But not binding for the Swiss Supreme Court, see BGer 15 January 2018 (2C_443/2017), E. 4.4.

within those “safe haven”-rules, the taxpayer is not affected by a tax adjustment.²⁹ The safe haven approach is in general highly recognised as a reasonable solution and it is also widely applied by most Cantons.³⁰

Very few Cantons have published different safe haven rules:

- In ‘Basel-Landschaft’ real estate companies have a debt capacity of 80%, and other industries may apply a debt capacity of max. 5/6 of assets;
- In ‘Schaffhausen’ the debt capacity is set at 85% of the fair market value of assets;
- In ‘Ticino’ real estate companies require at least 20% equity;
- In ‘Grisons’ the debt capacity is set at 80% of the fair market value of assets;
- And in ‘Zug’ real estate companies have a debt capacity of 80% and the companies in other industries have a debt capacity of 6/7 of assets.

If one applies the SFTA safe haven approach in determining the debt capacity, the benchmark is against the assets. It is undisputed that the underlying value of the assets should be their fair market value.³¹ However, Swiss accounting law is governed by the principle of prudence and the values are normally deviating from the (higher) fair market values. So it is up to the tax payer to demonstrate the fair market value of the assets, either by means of a balance sheet that is governed by other accounting rules that follow a ‘true and fair’ view approach (e.g. US GAAP, IFRS), or by means of a valuation report from an independent appraisal.³² If the company runs the accounts in other currencies than Swiss francs, the functional currency shall apply for the thin capitalisation determination.³³

2.1.4. *Determination of relevant thin capitalisation (debt and interest capacity)*

The mentioned asset/debt ratios, however, do not yet indicate what the maximum interest capacity of a tax payer is. In this respect, the following examination catalogue is decisive for the determination of thinly capitalised companies:³⁴

1. Determination of the relevant debt capital without consideration of various special situations (such as: financing of extraordinary business transactions, interest free debt capital, taxed hidden reserves);
2. Identification of harmful lenders because only debt capital which is directly or indirectly from related parties can be relevant; and

²⁹ See P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 58.

³⁰ See overview in R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 265.

³¹ See Circular Letter 6/1997, page 2; various Swiss Supreme Court decisions (the latest being BGer 20 April 2017 (2C_814-815/2015), cons. 7.4); see with further references R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 251; P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 55.

³² See R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 257 et seq.

³³ See BGer 30 September 2015 (2C_560-561/2014), cons. 3.4.

³⁴ See more details in R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 227 et seq.; similar steps according to P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 42 et seq.

3. Benchmarking of the financial structure and determination of the maximum debt capacity, either according to the Circular Letter 6/1997 ("safe haven"-approach) or with economically common procedures.³⁵

On an annual basis the SFTA publishes safe haven interest rates that apply to related party financing which are then relevant to calculate the interest capacity.³⁶ It is up to the tax payer to prove that deviating interest rates on shareholder loans are at arm's length.

This leads to the following situations: In case the Swiss company pays arm's length interests on the recognised debt portion then the tax deductibility of the exceeding interest expense, paid on the thinly capitalised debt, will not be granted.³⁷ In case the Swiss company pays interest rates on the recognised debt that exceed the arm's length principle then the tax deductibility of the sum of recognised debt times arm's length interest rates will be granted, but not the exceeding interest expense even if partially paid on the recognised debt.³⁸ In case the Swiss company pays interest rates below arm's length then the sum of the arm's length interest rates times the recognised debt is considered as the maximum amount tax deductible interest expense, i.e. the interest capacity. Corporate tax adjustments for this kind of deemed dividends are on a permanent basis and do not impact on the financial accounts, but are adjustments in the tax assessment only.³⁹

2.1.5. *Benchmarking of the financial structure*

In economics there is not a single correct percentage of the level of adequate debt financing of companies in general. An optimal capital structure applicable to all companies can economically not be derived, neither empirically nor theoretically.⁴⁰ A review whether or not loans are at arm's length may be understood as a link to the financing market, which means that the market conformity of the respective loan will be tested. Therefore, the decision of the financing structure regarding interest, collaterals, covenants, amortisation, etc. has to be at arm's length. In order to examine the market conformity, the (upside) chances and (downside) risks of the capital investment are critically reviewed. If neither the safe haven approach according to Circular Letter 6/1997 shows conclusive results nor a concrete third-party comparison regarding the potential credit financing is available, the following steps may depict the procedure regarding the determination of the market conformity of the tested financing structure:⁴¹

³⁵ See section 2.1.5.

³⁶ See Rundschreiben SFTA, 31 January 2019 (Swiss franc nominated loans) and 1 February 2019 (other currencies nominated loans).

³⁷ See, also for the other options, R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 285 et seq.; P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 65 et seq.

³⁸ See BGE 15 January 2018 (2C_443/2017), E. 4.3.

³⁹ See R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 285

⁴⁰ See Modigliani/Miller, The Cost of Capital, Corporation Finance and the Theory of Investment, in: American Economic Review, June 1958, p. 261 et seq.; Von Wysocki, Zur Frage der angemessenen Eigenmittelausstattung aus betriebswirtschaftlicher Sicht, in: Wysocki/Höhn, "Fremdfinanzierung" von Kapitalgesellschaften durch Anteilseigner, München 1982, 1 et seq.; see detailed overview in R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 21 et seq.

⁴¹ See R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 281 et seq.; P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 61.

1. The first step is to determine the maximal debt capacity of the debtor;
2. The second step is to test with various key figures whether the debt financing is at arm's length: EBITDA-to-interest costs, debt-to-EBITDA, FCF-to-interest costs, FCF-to-debt, contractual payback period-to-FCF/debt, debt-to-liabilities.

This is, however, a transfer pricing driven approach that requires a certain expertise in this field but may help in arguing in favour of a higher debt level than according to the Circular Letter 6/1997. Such approach is, however, rather the exception as it is very common in practice to use the safe haven guidelines or to find another pragmatic solution in order to calculate the excessive interest payments.

2.1.6. *Personal scope of thin capitalisation rules and relevant lenders*

The mentioned safe haven rules apply appropriately (as a first triage) to the following taxpayers: Industrial companies, real estate companies, head office companies, investment holdings and finance companies. The Circular Letter 6/1997 does, however, not apply to taxpayers from certain specific sectors (i.e. banks and insurance companies) which cannot be allocated to a certain class of the Circular Letter 6/1997 or have regulatory rules regarding their capital base.⁴² In fact, market-tested methods or regulatory models should indeed overrule the Circular Letter 6/1997 and be in line with the “substance over form” approach of art. 65 FDFT or art. 29a FTTHA.

Not only Swiss companies but also Swiss cooperatives are subject to the thin capitalisation rules, pursuant to art. 65 FDFT or art. 29a FTTHA. The same applies to Swiss branches of non-Swiss entities.⁴³ Moreover, the legal wording of art. 65 FDFT (and art. 29a FTTHA) does not refer to a particular class of lenders that would fall into the scope of the rules. Just a few cantonal tax laws refer to “related parties”. Given the substance and purpose of the rules, either the shareholder or related parties to the shareholder would qualify as potentially harmful lenders. Third party lenders do not fall into the scope of the rules. However, SFTA stipulated in the Circular Letter 6/1997 that third party debt secured by a related party could nevertheless fall into the scope of the rules.⁴⁴ In the meantime this view has generally been confirmed by the Swiss Supreme Court.⁴⁵ Another key issue is to determine if the third party has solely debt funded thanks to the security from the shareholder, in other words has replaced the required shareholder financing, or if the security package reduces the risk margin on the debt financing by the third party. In the latter case there should be no room for a re-classification as this should not violate against the meaning of the thin capitalisation rules understood as anti-avoidance rules. Harmful lenders are therefore either shareholders or related parties to the shareholder.⁴⁶ Other lenders, in particular independent third party lenders, should not be considered as harmful lenders.

⁴² See R. Böhi, *Das verdeckte Eigenkapital im Steuerrecht*, p. 272 et seq.

⁴³ See P. Brülisauer/M. Dietschi, *Kommentar zum Bundesgesetz über die direkte Bundessteuer*, Basel 2017, art. 65 § 73; R. Böhi, *Das verdeckte Eigenkapital im Steuerrecht*, p. 199 et seq.

⁴⁴ Circular Letter 6/1997, p. 2.

⁴⁵ See BGE 142 II 355; for a detailed differentiation of the various security concepts see R. Böhi, *Das verdeckte Eigenkapital im Steuerrecht*, p. 238 et seq.

⁴⁶ See BGE 31 August 2012 (2C_77/2012), E. 3.4, in which the Swiss Supreme Court confirmed that subordinated debt from the shareholder, pursuant to art. 725 (2) Swiss Code of Obligations, does not *by default* re-qualify this debt into deemed equity for tax purposes.

2.1.7. Interpretation of the legal wording

The afore-mentioned wording of article 65 FDFT, i.e. the Swiss thin capitalisation rule, leaves room for interpretation as it uses unspecific terms. According to the wording of the provision, “[t]he taxable income of corporations and cooperatives includes those parts of interests on debt which belong to debt capital but have the economic meaning of equity capital”. Therefore, the debt under scrutiny needs to have the relevant equity specific functions to justify a re-characterisation. This is quite a tough hurdle, and today’s language of the applicable rules is also a clear deviation from the previous case law as developed by the Swiss Supreme Court that was driven by a tax-avoidance approach and mainly focused on real estate companies. In these cases, the level of debt financing was decisive and not the functions of financing instruments as such.⁴⁷ It is, however, our understanding, that for the determination of the thin capitalisation, the questionable debt funding needs to have the economical functions as *quasi-equity* to become re-characterised.⁴⁸ Therefore, the basic functions of the two capitalisation forms (debt or equity) should always be considered and the level of debt-funding cannot solely be decisive. Only to the extent that the following elements are cumulatively met, should a re-characterisation from debt into equity be permissible under Swiss tax laws:⁴⁹

1. No relevant economic debt capital functions is left, and
 2. The business risk of the creditor has to be equal to the business risk of the equity sponsor.
- The current practice of the authorities as outlined above is, however, infringing such an understanding of the wording of the provision.

2.1.8. Policy outlook

As outlined above, the wording of article 65 FDFT (and article 29a FTHA) implies an economic approach (“*substance over form*”). The administrative practice in Circular Letter 6/1997 on the other hand is based on an asset/debt approach applying a “*form over substance*” in the sense that the economic functions are not of relevance. The latter approach is not compatible with the legal concept that refers to the quality of the financing instrument.⁵⁰ One aspect of the latter approach is that in most cases it provides the tax payer with a feasible and transparent division between disallowed and allowed financing structures. This however is not in line with the wording of the law. Therefore, the abovementioned administrative practice is according to our view not compliant with the law, especially not if the distribution of the burden of proof is considered with the arm’s length principle. Therefore, *de lege ferenda*, either an adjustment of the wording of article 65 FDFT (and article 29a FTHA) or an adjustment of

⁴⁷ See, for instance, BGE 90 I 217.

⁴⁸ See for detailed review of the provision see R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 265 et seq.; Hongler, hybride Finanzierungsinstrumente, 51 et seq.

⁴⁹ See R. Böhi, Das verdeckte Eigenkapital im Steuerrecht, p. 283; P. Brülisauer/M. Dietschi, Kommentar zum Bundesgesetz über die direkte Bundessteuer, Basel 2017, art. 65 § 29.

⁵⁰ However, see BGE 20 April 2017 (2C_814-815/2015), E. 8.1 in which the Swiss Supreme Court stated that the debt which qualifies as deemed equity refers to the thin capitalisation (original in French: “*la part de capital étranger économiquement assimilable au capital propre se réfère au capital propre dissimulé*”).

the administrative practice to the wording of the law should be evaluated.⁵¹ If an adjustment of the wording is considered, it might be an option to implement a recommended rule in line with BEPS Action 4. However, recent indications by the competent Swiss governmental bodies imply that the introduction of an interest limitation rule such as also suggested by article 4 of the ATAD, is unlikely.

2.2. Tax consequences of thin capitalisation

2.2.1. Introduction

As outlined, Switzerland re-characterises excessive interests as non-deductible distributions (i.e. deemed dividends or constructive dividends) on a permanent basis.⁵² This has tax consequences discussed in the following paragraphs.

2.2.2. Corporate income taxes

Assuming that the debt funded by the related party is exceeding the debt capacity pursuant to the aforementioned approach, in other words the Swiss company should be considered as thinly capitalised, then the exceeding interest expenses will not be tax deductible at the level of the Swiss company.⁵³ The effective tax rates vary from Canton to Canton and are currently between 12% and 24% (2018, including federal tax).

2.2.3. Withholding taxes

Switzerland levies 35% withholding tax on dividends of any kind.⁵⁴ This also applies to non-recognised interest expenses due to the application of the thin capitalisation rules. The SFTA must receive the payment and the declaration within 30 days after maturity of the deemed dividend.⁵⁵ The issue is to determine the point in time of the maturity of a deemed dividend. Without further evidence, the SFTA would argue that the maturity date is 30 days after closing of the financial statements. From this point in time, the SFTA would also levy late payment interest of 5% per annum after such date.

The Swiss withholding tax has to be borne by the recipient of the taxable payment (ultimate taxpayer).⁵⁶ Switzerland usually applies a refund system for withholding tax levied on dividends payments. This means that if withholding tax is due, a Swiss person liable for tax

⁵¹ See P Hongler/R. Böhi, *Unterkapitalisierung oder verdecktes Eigenkapital? Eine rechtliche und steuerpolitische Analyse der Schweizer Rechtspraxis unter besonderer Berücksichtigung von BEPS Action 4*, FStR 2016, 126 et seq.; dissenting opinion P. Brülisauer/M. Dietschi, *Kommentar zum Bundesgesetz über die direkte Bundessteuer*, Basel 2017, art. 65 § 39.

⁵² See s. 2.1.2.

⁵³ See BGer 15 January 2018 (2C_443/2017), E. 4.3; BGer 10 August 2015 (2C_1108/2014), E. 2.3 in which the Swiss Supreme Court confirms that the Swiss corporate tax does not recognise a consolidated approach when it comes to the determination of tax deductible interest rates.

⁵⁴ Art. 4 (1) (b) in connection with art. 13 (1) (a) WTA.

⁵⁵ Art. 16 (1) (c) WTA.

⁵⁶ Art. 14 WTA.

has to deduct and pay the full 35% tax even when a double tax treaty provides for a reduction of the tax rate or even a 0% tax rate. In a context with a Swiss parent company owning at least 20% in the Swiss company distributing a deemed dividend, the unilateral notification procedure should be granted by SFTA. Another issue results from the situation that if the Swiss withholding tax was not borne by the recipient, then SFTA adjusts the tax basis (if the net payment is 100, then the tax basis is 153.84 [$100 / 100 * 65$]) and the tax rate would increase to 53.8% (35% on 153.84).

2.2.4. *Capital taxes*

Capital taxes are levied on the net equity of a tax payer and are only due on cantonal and municipal level.⁵⁷ The Federation does not levy capital taxes. The non-recognised debt will be added to the tax basis for capital tax purposes. The tax rates vary from Canton to Canton and are between 0.001% and 0.53% (2018).

2.2.5. *Stamp duty*

Based on a long-standing practice the SFTA does not levy one-time stamp duty of 1% on the non-recognised debt as the stamp duty law foresees a formalistic approach. To the extent that these loans would however be swapped into real equity, the 1% charge would be due unless a financial restructuring exemption would apply.⁵⁸

2.3. **Cross-border situations**

Section 4 will outline the tax treatment of excessive interest payments in a cross-border situation.

2.4. **Limitations that disallow interest deductions without any re-characterisation**

Switzerland does not know any rules disallowing interest deductions without a re-characterisation of such interests into dividends. Therefore, in all cases of excessive interest payments, the authorities assume a constructive or deemed dividend payment triggering the aforementioned tax consequences.

⁵⁷ Art. 29 et seq. FHTA.

⁵⁸ See art. 6 (1) (k) or art. 12 SDA.

3. Implementation of the BEPS Action 4 report

Switzerland has not introduced and has not intended to introduce an interest limitation according to BEPS Action 4. Moreover, Switzerland as a non-EU member state is also not forced to introduce any measure contained in the ATAD, in particular article 4 ATAD.

4. Domestic rules addressing foreign interest-limitation rules

In case an interest paid to a Swiss resident lender is not deductible due to the application of foreign interest limitation rules, Switzerland does not provide for specific rules to mitigate double taxation in such situation. Switzerland would not change its interest classification if a certain payment is not deductible abroad due to the application of interest limitation rules. However, if it is proven that the interest was not considered to be at arm's length, it would be possible to amend the applicable interest rate if an agreement between states has been reached through a mutual agreement procedure. Though, if the recipient is the parent company of the borrower, the question occurs whether the Swiss participation relief would be applicable on such excessive interest payments.⁵⁹ The SFTA has published a practice in this respect allowing the application of the participation relief if (i) the Swiss authorities would conclude that a reclassification would also be justified from a Swiss perspective or (ii) that a mutual agreement procedure is at hand.⁶⁰ Therefore, if the other state applies rules in line with BEPS Action 4 and denies deduction, even though an individual interest payment would be at arm's length, then the Swiss participation relief would probably not be applicable in a parent subsidiary relation.

5. Mutual agreement and other mechanisms for avoiding double taxation

5.1. Before BEPS Action 4

As a preliminary remark and as mentioned above, it is important to note that the application of the Swiss thin cap rules leads to a reclassification of the interests into dividends for withholding tax purposes. Or to be more precise, the excessive interests are considered to be deemed dividends and subject to withholding taxes in Switzerland. The question is whether the recipient could ask for a full or partial withholding tax refund.

First of all, it is important to note that for the determination of the recipient Switzerland in general follows a direct attribution rule;⁶¹ i.e. the relation between the borrower and the lender is decisive. Second, in order to answer this, it must be reviewed whether the recipient

⁵⁹ See s. 2.1.2.

⁶⁰ Circular Letter No 27, s. 2.4.1.

⁶¹ See SFTA Leaflet as regards the determination of the recipient for withholding tax purposes (Merkblatt zur Bestimmung des Leistungsempfängers bei der Verrechnungssteuer), February 2001.

has access to the protection of a tax treaty and, in particular, which treaty article would be applicable.

It is the practice in Switzerland that such excessive interests qualifying as constructive dividends for domestic corporate income and withholding tax purposes are also qualified as dividends for treaty purposes. This means that the dividend article and not the interest article of a treaty applies. There is, however, no detailed discussion whether this is indeed true or whether it seems more persuasive that such excessive interests are still interests for treaty purposes.⁶² As a consequence, if the payments are classified as dividends for treaty purposes, a full refund of Swiss withholding taxes is only possible if the lender is the parent company of the borrower and if the treaty contains a 0% rate in the dividend article for intra-group situations; or *e contrario*, a full refund is not possible if the lender and the borrower are sister companies.

Switzerland does not have specific cross-border interest-limitation rules. The mentioned thin capitalisation rules apply notwithstanding the fact whether the lender is a resident company in Switzerland or abroad. Such rules are also not discriminatory in the sense of article 24 of the OECD-MC.

5.2. After BEPS Action 4

As mentioned above, Switzerland has not changed any rules or regulations due to BEPS Action 4. There is currently also no legislative project in the pipeline. This is also true for measures avoiding double taxation.

⁶² For a more detailed analysis see P. Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz*, Zurich 2012, p. 300 et seq. See also S. Oesterhelt / R. Heuberger, in: *Kommentar zum internationalen Steuerrecht*, Basel 2015, art. 10 § 266b.



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