Switzerland
Bär & Karrer

Group financing

Interest paid on bonds as defined by the Swiss Federal Tax Administration (SFTA) for Swiss withholding tax (WHT) purposes, which may also include certain types of syndicated loans, issued by a Swiss tax resident debtor is generally subject to WHT at a rate of 35%. This may have an adverse impact on the competiveness of the Swiss capital market.

The significant adverse tax consequences of the qualification as a Swiss bond have raised questions regarding the differentiation between Swiss financing and foreign financing. A pro-forma issuance through a foreign subsidiary without sufficient substance (i.e. a special purpose vehicle) qualifies as Swiss financing triggering adverse WHT consequences as if the bond were issued by the Swiss parent company. However, for debt financing through a foreign group entity with sufficient substance, the SFTA have developed rules defining the requirements for a possible re-characterisation of a foreign bond as a Swiss bond.


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Bonds issued by foreign subsidiaries with downstream guarantee

A downstream guarantee from a Swiss parent enables a foreign subsidiary with a low credit rating to raise capital benefitting from lower interest rates. This is due to the unlimited guarantee of the parent company with a higher credit rating. Therefore, the conditions of the SFTA for not assuming a Swiss bond are quite strict.

Currently, the following two requirements, which must both be met, result in a possible re-characterisation of a foreign bond as a Swiss bond issued by a foreign subsidiary with sufficient substance:

(i) down-stream guarantee from a Swiss parent; and
(ii) What is known as the direct or indirect harmful use of proceeds in Switzerland.

Legally speaking, a foreign bond could only be attributed to a Swiss parent in the case of tax avoidance. However, in practice, because of the significant effect of a possible re-characterisation, these two requirements are used as safe haven rules. In borderline cases, the exact meaning of the conditions is often unclear and hence the qualification is clarified in the form of a tax ruling request filed with the SFTA.

(a) Down-stream guarantee

As guarantor, the Swiss parent is not treated as a direct debtor under a financing agreement. However, in the event of a default, it is unconditionally and directly liable *vis-à-vis* the investors for the re-payment of the principal and the payment of interest. Even a keep-well agreement with a less formal commitment of the Swiss parent or the pledging of assets of the Swiss parent may be treated like a potentially harmful guarantee for the qualification as a foreign or Swiss bond.

Due to the strict guarantee limitations required from a Swiss company law perspective, upstream or cross-stream guarantees are generally not considered as harmful for the qualification as a foreign bond, unless there is a case of tax avoidance.

(b) Harmful use of proceeds

As a second criterion, the proceeds must not be used directly or indirectly (through another group company) in Switzerland by the Swiss parent or by other Swiss subsidiaries. In case of mixing the proceeds originating from the debt financing and operating earnings of the foreign entity, this requirement results in a *de-facto* interdiction of forwarding cash into Switzerland. Especially in such cases, it is in practice challenging to prove the use of the proceeds abroad.

In practice, the SFTA verifies whether the balance sheet of the Swiss parent has been extended by a loan from the foreign issuer. However, a dividend distribution from the foreign entity to the Swiss parent, should not be harmful for the qualification of the foreign bond. The question of what amount of the proceeds used in Switzerland is seen by the SFTA to be harmful is still not entirely solved. The answer can vary depending on the facts in each individual case. Therefore, it is recommended to file a tax ruling request with the SFTA in unclear cases.

(c) Impact on cash-pooling

Swiss resident groups must also consider that by using downstream guarantees from Swiss entities for debt financing abroad, they are not allowed to profit from the privilege for group companies to treat credits between group companies neither as loans nor as customer credit balances. Without this privilege, it is not possible for larger Swiss groups to introduce an effective cash pooling within the group without triggering adverse WHT consequences. Therefore, on September 23 2016, the Swiss Federal Council opened a public consultation process with a view to introducing less strict rules applicable to downstream guarantee arrangements of Swiss groups. Based on the planned amendment, the proceeds from a foreign debt financing could be forwarded to a Swiss company by the foreign issuer – without losing the possibility of claiming the privilege for group companies – provided the forwarded proceeds do not exceed the equity of the foreign entity/issuer. The planned revision will not have an impact on the question of whether the use of proceeds received from the issuance of a bond is considered harmful.

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