PESTALOZZI

ATTORNEYS AT LAW

Swiss thin capitalization rules

15.07.2019

Key takeaways

As in other countries, Switzerland has Swiss thin capitalization rules. As opposed to other countries, Switzerland's thin capitalization rules have these following specific features:

- Swiss thin capitalization rules apply only to "related party debt" (including third party debt secured by a related party).
- Swiss thin capitalization rules do not establish a fixed debt/equity ratio; rather, each Swiss company has its individual borrowing capacity, depending on the company's assets.
- While interest expense - disallowed under Swiss thin capitalization rules - is not tax deductible, it constitutes a Swiss company's deemed dividend distribution, which is subject to a 35% Swiss dividend withholding tax.

What are Swiss thin capitalization rules?

In Switzerland, there are thin capitalization rules (often called "hidden equity" rules). These thin capitalization rules establish a maximum borrowing capacity and a cap of interest deduction.

Swiss thin capitalization rules apply if debt is considered, for tax purposes, "related party" debt (as opposed to "third party" debt).

The rationale behind this rule is to disallow debt recognition for Swiss tax purposes to the extent related party debt exceeds the (deemed) amount of debt that the Swiss company would be able raise from independent third parties.

A debt position is considered "related party" debt, if:

- the debt is raised directly from a related party (i.e., the lender is a related party); or

- a related party has granted security for debt raised from third parties (so called "indirect" related party debt).

Broadly speaking, a "related party" is a direct or indirect shareholder of the Swiss company and any other group company.

If the related party debt exceeds the maximum borrowing capacity, as defined by the Swiss thin capitalization rules, then the exceeding debt is treated as equity and subject to an annual net capital tax. If the cap of interest deduction, as defined by the Swiss thin capitalization rules, is exceeded, then interest expense disallowed under the Swiss thin capitalization rules is not tax deductible and constitutes a deemed dividend distribution by the Swiss company, which is subject to a 35% Swiss dividend withholding tax.

How is the maximum borrowing capacity calculated?

Contrary to the thin capitalization rules as they apply in other countries, in Switzerland, there is no fixed debt/equity ratio. Instead, each Swiss company has its individual borrowing capacity, depending on the kind and value of assets it currently holds. Thus, the Swiss thin capitalization test rests on a "floating" basis.

The Swiss Federal Tax Administration has issued a circular letter that establishes deemed / lump sum safe harbor borrowing capacity thresholds for various kinds of assets (e.g., a company's held participations have a 70% deemed borrowing capacity). This test will be applied based on the assets' stand-alone Swiss book values, unless the Swiss company can show that the assets' market value is higher. The local tax authorities in certain Swiss cantons apply rules that may deviate from the Swiss Federal Tax Administration's circular letter.

Considering all assets the company holds and their borrowing capacity, what results is a "blended" overall borrowing capacity. This "blended" overall borrowing capacity expresses the maximum amount of debt that the Swiss company can have if related party debt is involved. This determination holds unless the company is able to demonstrate that third parties would have granted more debt.

How is the cap of interest deduction calculated?

To calculate the maximum amount of interest expense that the Swiss company can deduct, the maximum amount of debt allowed under the hidden equity rules (see above) must be multiplied by the "safe harbor interest rates" that the Swiss Federal Tax Administration annually publishes for various currencies ("default thin capitalization maximum interest expense").

If the interest expense actually booked at the level of the Swiss company is higher than the "default thin capitalization maximum interest expense", a clear risk emerges that the excess interest expense is not tax deductible but treated as a deemed dividend distribution. The Swiss company may demonstrate, however, that the higher total amount of interest expense as actually booked is at arm's length. If this scenario can be shown, the interest expense is accepted as compliant with the Swiss thin capitalization thresholds.

What are the tax consequences if the thin capitalization thresholds are exceeded?

If the related party debt exceeds the maximum borrowing capacity, as defined by the Swiss thin capitalization rules, this debt is re-characterized "hidden equity", i.e., not treated as debt but rather as equity for Swiss tax purposes.

Swiss companies are subject to an annual capital tax on their net equity, as shown in the statutory stand-alone financial statements. The immediate consequence of such re-characterization of related party debt as "hidden equity" is that the debt position is added-back to the taxable capital and is thus subject to Swiss annual capital tax.

Another tax consequence of the re-characterization of debt as "hidden equity" is that interest expense, falling upon the "hidden equity" (and provided the "default thin capitalization maximum interest expense" is exceeded, see above), will not be recognized as a tax deductible cost item; rather, it will be treated as a deemed dividend distribution. Switzerland levies a withholding tax on dividend distributions at a 35% domestic rate, which also applies to interest expense caught by the thin capitalization rules. Under the current legislation, the recipient of the taxable payment (i.e., recipient of the interest payment) must bear the 35% Swiss dividend withholding tax. Thus, the Swiss company must either actually withhold 35% from the interest payment, or, the interest payment's recipient must pay the 35% Swiss dividend withholding tax to the Swiss tax authorities.

If Swiss dividend withholding tax is due on the (re-characterized) interest expense and not borne by the recipient of the interest payment, the withholding tax charge incurred by the Swiss company on the deemed dividend distribution is grossed up to approx. 54% (example: 100 / 65 * 100 = 153.84 thereof 35% = 53.84).

Is double tax treaty relief available?

In a cross-border context, the 35% Swiss withholding tax deduction is subject to double tax treaty relief (where available). Because the interest expense is treated as a deemed dividend distribution (as opposed to an interest payment), treaty relief must be sought under the double tax treaty's dividend article, rather than under the treaty's interest article.

Treaty relief is available only to the "recipient" of the income item. Under Swiss tax practice, as opposed to other countries' tax practice, the "recipient" of the re-characterized interest payment, i.e., the recipient of the deemed dividend distribution, will not per se be the shareholder of the Swiss company; rather, this recipient will be the lender collecting the interest income from the Swiss company.

Thus, if the lender is not the direct shareholder, the lender is not able to obtain full (or privileged) treaty relief (under the zero / privileged DTT rate for qualifying participations) but must rely on the treaty's portfolio rate (resulting in a non-recoverable residual Swiss withholding tax burden). The portfolio rate treaty relief will be granted only as a refund (i.e., the Swiss company must actually withhold the tax, and the recipient must file a refund application with the Swiss tax authorities), rather than as treaty relief at source.

Nils Harbeke

Partner
Swiss Certified Tax Expert, Attorney at law
Head of Tax Practice Group

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 92 24
nils.harbeke@pestalozzilaw.com

Ludivine Boisard

Partner
Attorney at law

Pestalozzi Attorneys at Law Ltd
Cours de Rive 13
1204 Geneva
Switzerland
T +41 22 999 96 44
ludivine.boisard@pestalozzilaw.com

Jonas Sigrist

Partner
Attorney at law, Swiss Certified Tax Expert

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 93 26
jonas.sigrist@pestalozzilaw.com

Silvia Zimmermann

Senior Counsel
Attorney at law, Dr. iur., LL.M.

Pestalozzi Attorneys at Law Ltd
Feldeggstrasse 4
8008 Zurich
Switzerland
T +41 44 217 92 48
silvia.zimmermann@pestalozzilaw.com