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Financing of Start-up and Early-Stage Companies with Convertible Loans: Swiss Tax Considerations

Convertible loans (**CLA**s) are often used to finance Swiss start-ups and early-stage companies because the Swiss legal system does not provide for any well-established and flexible alternatives such as a SAFE (Simple Agreement for Future Equity) or similar instruments typically used in other jurisdictions prior to a classic financing round.

In the event of CLAs, not only the interest, but also the conversion discount will be subject to income tax for Swiss private investors and - if the 10/20 non-bank rules cannot be complied with - to withholding tax for the company, that is, for the borrower. The situation is different for so-called "classic" CLAs', where the conversion discount is not subject to either income or withholding tax.

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Withholding Tax

If a company issues a CLA for an amount of more than CHF 500,000 in total and applies "identical terms" (interest, conversion discount, currency, term, etc.) on these CLAs to more than 10 (non-bank) lenders, or issues CLAs with different terms to more than 20 (non-bank) lenders in total, or raises interest-money otherwise from more than 20 non-bank lenders (so-called **10/20 non-bank rules**), the SFTA qualifies the CLA as a convertible bond and levies 35% withholding tax on the interest payments when the interest is due.

"Identical terms" is interpreted by the Swiss Federal Tax Administration (**SFTA**) quite narrowly. Even small differences or changes in the terms of the CLA (e.g. a different interest rate, a different conversion discount, a different duration, etc. may be sufficient for there to be no "identical terms" and thus the CLA to fall outside the 10 non-bank rules (and thus to only be subject to the 20 non-bank rule).

In the event that the 10/20 non-bank rules are not observed, the SFTA generally qualifies the convertible discount as an interest payment and levies withholding tax on it as well unless it classifies the CLA as a classic convertible bond (*in German: klassische Wandelanleihe*). In the event of a classic convertible bond, only the coupon paid periodically will be subject to withholding tax. However, a CLA with a conversion discount of more than 20% no longer qualifies as a classic convertible bond pursuant to the current practice of the SFTA.

Debt funds as lenders are treated as non-transparent, that is, as one lender only, with regard to the 10/20 non-bank rules, even in the absence of a legal personality (such as a limited partnership), although they are typically tax-transparent for general tax purposes. It is market and good practice to get this confirmed by the SFTA by way of an advance tax ruling.

If the 10/20 non-banking rules are complied with, the CLA will be an individual loan rather than a bond for withholding tax purposes. This means that the conversion discount and the interest payments are generally not subject to withholding tax.

However, Swiss withholding tax will still be due, irrespective of the qualification of the CLA as a convertible bond or individual loan, if the interest is requalified as a constructive dividend. This will be the case if the CLA is held by an existing shareholder or a related party when entered into and the interest on the CLA is not at arm's length according to the rules set out by the SFTA (which publishes safe harbour rates every year) or if the company is thinly capitalised for tax purposes. A welcome exception applies with regard to accrued interest which is not paid in cash, but rather by the issuance of additional shares upon conversion of the CLA. The reasoning behind this exception is that an issuance of new shares constitutes a redistribution of the shareholdings in the company between the shareholders, but no actual outflow by the company. This holds true even in the event that the lender has a choice between an actual cash payment and a delivery of newly created shares, assuming that the lender opts for shares prior to any interest payment.

Income Tax

The interest on CLAs, whether individual loans or bonds, is subject to income tax for Swiss private lenders who hold CLAs as private assets. This applies irrespective of whether the interest is paid periodically (coupon) or at the end of the term or at conversion. Nor does it matter whether the interest in question is paid in cash or in kind (e.g. by issuing new shares in the company).

The interest on CLAs is not limited to the coupon, but also includes the conversion discount which will thus be subject to personal income tax as a general rule.

However, in the event of a classic CLA, being an individual loan or a bond, the conversion discount is not subject to income tax.

Issuance stamp tax

Upon conversion of a CLA, issuance stamp tax at a rate of 1% will fall due on the amount that is converted to equity.

Comment

When financing start-ups and other early-stage companies with CLAs, it is important to avoid withholding tax primarily for foreign lenders, which, like funds, would not qualify for a refund, by subjecting the CLA and the company to the 10/20 non-bank rules and restrictions. As part thereof, it is of utmost importance to put the company in a position to properly count and monitor the non-bank lender slots. In the event of debt funds as lenders, there will typically be a need for a tax ruling confirming that the debt fund, which for tax purposes is normally a look-through structure, counts as one lender only for the purpose of the 10/20 non-bank rules.

Should a more broadly structured financing be required in excess of the 10/20 non-bank rules and restrictions, one would, if feasible, normally try and structure it as a "classic" convertible bond by limiting the conversion discount to 20% or less and avoid periodic interest payments.