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Structuring of private equity acquisitions in Switzerland

The acquisition and sale of a Swiss company by a private equity firm is associated with numerous and partially peculiar tax challenges that should be considered when setting up a suitable acquisition structure.

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Swiss Withholding Tax

In recent years, the Swiss tax authorities have developed a rather sophisticated and strict practice on the avoidance of treaty shopping and/or treaty abuse to eliminate or mitigate Swiss withholding tax (WHT) on dividends. The problem arises not only in the event of profit distributions by the target group to the acquisition company (to pay down bank debt) or to the private equity fund (recapitalisation), but also in the event of a resale.

(a) In the event of a foreign acquisition vehicle

The private equity fund itself is, in most cases, not entitled to claim benefits under a double taxation agreement.

This is why regular attempts are made to locate an interposed acquisition company in a state that has concluded a double taxation agreement with Switzerland, which generally allows complete relief from dividend WHT (i.e. a zero-rate state).

However, the requirements that the Swiss Federal Tax Administration (SFTA) places on the substance of a foreign acquisition company for the use of double taxation agreements are high. Apart from balance sheet substance (30% equity capitalisation), the foreign acquisition company must also have either functional or personnel substance. Generally, private equity funds rarely have functional substance because the acquisition company is typically a special purpose vehicle (SPV) and therefore has no other substantial holdings. The requirements placed by the SFTA on personnel substance are high and will generally only be met if the private equity firm maintains a management company in the country of domicile of the acquisition company with locally active persons who perform essential functions in the monitoring and management of Swiss and other target companies of the respective fund family. Minimum regulatory or corporate law requirements (e.g. appointment of local service providers to the board of directors) are just as insufficient as on-site meetings of the investment committee.

Private equity funds holding their portfolio companies via a (bundling) master holding company (e.g. in Luxemburg) with separate subsidiaries for the various targets typically qualify for the benefits under the respective double taxation agreement with Switzerland based on the alternative functional substance test (which will be met if the master holding company holds at least one other substantial participation in a third country apart from the Swiss target).

(b) In the event of a Swiss acquisition vehicle

Due to the elevated requirements that the SFTA places on the substance of a foreign acquisition company, a domestic acquisition company is often chosen for many private equity funds rather than a foreign one.

Under Swiss law, a domestic acquisition company is entitled to a full refund of WHT on dividends received by it (from the target company). Generally, via the creation of paid-in capital and the granting of shareholder loans by the private equity fund, the way may be paved for the repatriation (abroad) of at least the funds made available to the acquisition company in Switzerland without WHT being deducted (which would normally suffice for any planned recapitalisations of the fund).

However, under the heading of an "extended international transposition" (i.e. tax avoidance), the SFTA unfortunately refuses to grant the Swiss acquisition company a refund of WHT (or the application of the reporting procedure) on distributions made by the domestic target company to the extent that the domestic acquisition company may distribute reserves without deducting WHT to a non-refundable purchaser (i.e. to the extent of the sum of the paid-in capital and shareholder loans).

If it can be demonstrated that the acquisition company functions as a vehicle for raising debt capital from third parties (banks) and/or has been set up for the purpose of seller re-investment and management participation, the SFTA will under certain circumstances refrain from asserting tax avoidance. Notably, this will be the case if the acquisition financing raised by the acquisition company from third parties exceeds the private equity fund's own financing or if, in the event of debt financing of less than 50%, the sellers and managers reinvest substantially in the acquisition company.

In the event of a two-tier acquisition company typically preferred by banks (Swiss HoldCo/Swiss BuyCo), no substrate (such as paid-in capital contributions reserves reflected as such and shareholders loans) may be created on the level of the domestic holding company which may be distributed out of Switzerland free of WHT. If, however, the banks' borrowed capital on the level of the acquisition company exceeds any shareholder loan, there will be no grounds on which the extended international transposition should apply.

Swiss equity stamp duty

In Switzerland, 1% issuance stamp duty is levied on capital contributions from (direct) shareholders to Swiss companies, which comprises the initial creation and subsequent increases of share capital, as well as contributions without any issuance of shares.

Within the current legal framework, there are various ways of lowering or avoiding said 1% issuance stamp duty, which is charged on equity capital. One common route is to fund Swiss companies through shareholders' interest-bearing or interest-free loans, which do not attract issuance stamp duty. However, interest payments present complexities due to the thin cap and maximum interest rules and the respective transfer pricing issues.

Due to the formal nature of the Swiss issuance stamp duty, it will only be levied in the event of a contribution by a direct shareholder. As a result, issuance stamp duty may be avoided if the contribution is made by an indirect grandparent company rather than the direct shareholder. For private equity firms with sufficient substance abroad to satisfy the Swiss anti-abuse substance requirements on the level of the interposed foreign holding company, allowing for WHT-free distributions of dividends out of Switzerland, grandparent contributions through a Swiss or foreign intermediate holding company are therefore quite often used to avoid said 1% issuance stamp duty.

For private equity structures which are not eligible for the treaty benefits, typically a two-tier acquisition structure financed by debt or equity on the level of lower-tier Swiss BuyCo rather than the level of Swiss HoldCo is chosen to avoid said 1% Swiss equity stamp duty.

Acquisition financing

(a) In general

Large Swiss acquisitions include either or both:

- the placement of acquisition term-loan tranches with institutional investors (rather than banks); and
- the issuance of high-yield notes.

In some transactions, a bridge financing is provided to facilitate the acquisition process and the closing mechanics, and arranged and refinanced by a high-yield notes financing as soon as possible after closing. Smaller Swiss domestic acquisition financing transactions, on the other hand, are often financed by Swiss banks, including Swiss cantonal banks and smaller financial institutions. This financing is usually held by the banks on their balance sheet until full repayment has been made.

(b) Non-Bank Rules

The mere provision of (acquisition) financing itself does not trigger a licensing requirement under Swiss laws. The tax structuring of acquisition financing transactions is more challenging, largely due to the Swiss Non-Bank Rules.

When structuring a syndicated financing transaction involving Swiss borrowers, the usual approach is to limit the number of non-banks (investors) to 10 so as to comply with the non-bank rules to avoid 35% withholding tax on the relevant interest payments. This approach is obviously not feasible in larger leveraged acquisition financing transactions, where term-loan tranches or notes are placed outside the banking market. Accordingly, funds under these transactions may not be raised by a Swiss borrower or issuer, but rather through top-tier vehicles incorporated abroad in a jurisdiction which has a beneficial double tax agreement with Switzerland (for the purposes of upstreaming dividends without triggering withholding tax). A foreign vehicle may either act as an acquisition vehicle or set up a Swiss acquisition vehicle itself if this is beneficial to the structure for other (tax) structural reasons.

Given the generally beneficial double tax agreement between Switzerland and Luxembourg, structures often involve multi-level acquisition vehicles incorporated in Luxembourg. If funds raised by a non-Swiss borrower are lent onwards within the group to a Swiss target company (or to a Swiss acquisition vehicle), this may be considered as a circumvention by the SFTA. This will be relevant if the Swiss target company or a potential Swiss acquisition vehicle guarantees and secures the acquisition financing in question.

However, the SFTA has previously considered and approved structures that have included these structural elements by way of binding tax rulings.

Nevertheless, this process must be carefully structured, considering the time required for obtaining tax rulings, particularly when using a Swiss acquisition vehicle (because the proceeds of the financing will be largely onward lent to a Swiss vehicle).

If the transaction includes a (revolving) working capital facility lent directly to the (Swiss) target companies, compliance with the non-bank rules can only be achieved by limiting the number of non-banks to ten. For the purposes of ensuring that the acquisition debt portion of the financing (which typically involves more than ten non-banks as lenders or noteholders) does not affect the working capital facility, it is important to structure these facilities in a manner that ensures their qualification as separate financings for the purposes of the non-bank rules. Against this background, loss-sharing provisions and similar (equalisation) provisions contained in inter-creditor arrangements must also be carefully structured or confirmed by the SFTA (by way of a tax ruling) against the Swiss non-bank rules.

(c) Pushdown of debt: deductibility of interest expense

Under Swiss tax law, for corporate income tax purposes, interest incurred on the level of the acquisition vehicle may not be offset against income generated on the Swiss target company level. This is because there is generally no tax consolidation under Swiss tax law (neither in Swiss domestic nor cross-border situations).

However, there will be some limited means of indirectly "pushing down" the acquisition debt portion, particularly if the existing debt can be refinanced on the target level. For the purposes of the Swiss Non-Bank Rules, this should be structured as a downstream loan from the acquisition vehicle to the target level (or by refinancing the existing debt on the target level, even though this would result in a limitation of the number of non-banks to ten for the portion of debt in question).

However, given the lending of the proceeds of the acquisition debt, the Swiss Non-Bank Rules would have to be carefully addressed. Alternatively, an (indirect) pushdown may be achieved by way of an equity-to-debt swap, where equity (freely distributable reserves or even share capital that can be reduced) is distributed, but not actually paid out, and then converted into a downstream loan. In recent transactions, an additional pushdown of debt potential has been created through a number of post-acquisition restructuring steps (such as intra-group sales of asset-generating additional earnings and the respective debt capacity).

Value added tax on advisory fees

In the context of a transaction, significant advisory costs are regularly incurred which are loaded with VAT. Careful tax planning is required to enable the acquiring company to recover all or part of this VAT.

A recent decision of the Swiss Federal Supreme Court has created new hurdles in this respect. According to this decision, an acquiring company will only be entitled to reclaim VAT on transaction costs incurred once it has been registered as a taxable person in Switzerland.

Timely formation and VAT registration of the acquiring company is therefore crucial for effective tax planning.

Management incentives

For private equity firms, providing ownership stakes and other equity incentives to key management employees at portfolio companies is an important step in aligning the interests of all stakeholders and building a foundation for growth.

Management is typically incentivised in private equity portfolio companies through a combination of the return on its own pari-passu investment (institutional strip) and a return on an incentive plan created by the portfolio company (sweet equity or incentive equity).

For Swiss employees, it is important to know that shares acquired at pari-passu conditions (that is, at the very same conditions as the PE fund) would be tax-free at exit. Typically, this is the preferred route for the sellers reinvesting some of their proceeds. Phantom shares and option plans exercisable only at exit (or any other cash event) would be taxed as salary (subject to normal personal income taxes and social security contributions), by contrast.

Should sweet equity be envisaged, one would sometimes split the investment into an institutional strip (at pari-passu conditions) and grant the employees the sweet element by way of phantoms/cash bonuses or separate shares. The sweet element, that is, the disproportionate return on invest (compared to an investment of the fund) would normally be taxable (and subject to social security payments) at exit.

Within certain limitations, one could, in some, but not all cantons, however, potentially be in a position to structure some tax-free sweetness for the Swiss employees by using two categories of shares (or interest-bearing loans), whereby the fund would finance the larger part of the transaction by means of additional loans or preferences shares. Typically, the ratio between loan or preferred shares (to be funded by the fund) and the common shares (to be funded by the fund and the employees) should be 4 : 1 (or lower) and the hurdle rate (for the preferred shares) or the interest on loans should be at least 6-8%). In order to get legal certainty, a tax ruling from the cantonal tax authorities in charge is required.

Comment

Setting up an ideal acquisition structure for private equity acquisitions in Switzerland is complex from a tax point of view and necessitates careful planning. Some topics must be discussed with the tax authorities and clarified in a binding and legally secure manner by means of tax rulings.

The Walder Wyss Newsletter provides comments on new developments and significant issues of Swiss law. These comments are not intended to provide legal advice. Before taking action or relying on the comments and the information given, addressees of this Newsletter should seek specific advice on the matters which concern them.

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