Intra-group debt financing: updated safe haven rates and thin capitalisation rules

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On 31 January 2019 the Swiss Federal Tax Administration (SFTA) published the 2019 safe haven interest rates to be used on intra-group loans. Against this backdrop, this article provides an overview of the relevant Swiss tax rules associated with determining whether intra-group financing constitutes equity or debt for tax purposes and the consequences of each characterisation.

Background

The establishment of a legal entity or the expansion of its business requires capital in the form of either debt or equity. A shareholder providing equity capital is generally compensated by dividend payments, which constitute a non-deductible cost for the company. On the recipient level, such dividend income is often exempt or favourably taxed in order to mitigate or avoid double taxation. Conversely, the provision of debt capital leads to interest expenses which are generally tax deductible on the company level and taxable in the hands of the payee.

Particularly in cases where the parties involved are related, the financing structure can be freely chosen and the person providing the capital may prefer to provide debt capital instead of equity capital. In cross-border situations or inter-cantonal situations within Switzerland where different tax rates apply, it may be beneficial if debt capital is provided by a low-tax group company to a high-tax group company to optimise the group's overall tax position. For instance, if the debtor of the intra-group loans is subject to a corporate income tax rate of 30% and the lender to a rate of 12%, the interest expense may be offset against taxable income at a rate of 30% and the interest income is taxed at 12% in the hands of the lender. In this financing structure, related group companies take advantage of the tax arbitrage and shift profits to the low-tax jurisdiction.

Given this situation, various countries have adopted anti-abuse rules to combat such financing structures and protect their tax base. Switzerland is one of those countries that has enacted tax-driven thin capitalisation rules which limit the debt-to-equity ratio and the interest rate paid on such intra-group loans. In addition, the safe haven interest rates published annually by the SFTA aim to prevent an unjustified erosion of the profit of a Swiss company.

In the following, the Swiss safe haven interest rates and the operation of the thin capitalisation rules in Switzerland are discussed in respect of intra-group loans granted to Swiss companies.

Overview

In general, debt capital raised by a Swiss company from independent third parties is not restricted and the interest paid therefrom is qualified as a tax-deductible business expense.

On the other hand, interest expenses on intercompany debt are tax deductible only on the level of a Swiss company provided that:

- the interest rate complies with the safe haven interest rates published annually by the SFTA or evidence is provided that the interest rate is at arm's length; and
- the loan granted by a related party does not qualify as hidden equity (ie, it is in line with the Swiss thin capitalisation rules).

Safe haven rates

In general

The SFTA's annually updated circular letters provide safe haven interest rates for intra-group loans. The applicable rates depend on the following:

- whether the loans are granted to or from a Swiss company (ie, whether it acts as a creditor or debtor);
- whether the loans were granted in Swiss francs or in a foreign currency; and
- whether the loans were secured.

The circular letters prescribe minimum interest rates for loans granted by a Swiss company to its shareholders and/or related parties and maximum interest rates for loans granted by the shareholders and/or related parties to a Swiss company in order to avert an unjustified erosion of the Swiss company's profit. If the safe haven interest rates are met, the SFTA assumes that the interests are at arm's length without requiring any further evidence.

Intra-group loans in Swiss Francs

The minimum interest rates for 2019 on loans denominated in Swiss Francs and granted by a Swiss resident company to shareholders and/or related parties are generally as follows:

- Equity-financed loans: 0.25%.
- Debt-financed loans: actual interest expense plus 0.5%. For debt-financed loans exceeding Sfr10 million, a mark-up of plus 0.25% must be applied on the actual interest rates.

The maximum interest rate for 2019 on loans denominated in Swiss Francs and granted by shareholders and/or related parties to a Swiss trading or production company is 1%. However, loans of up to Sfr1 million granted to a Swiss trading or manufacturing company may bear interest of up to 3%.

Different interest rates apply to loans secured by real estate and loans granted to Swiss holding and asset management companies.

Intra-group loans in foreign currencies

The safe haven interest rates for loans denominated in foreign currencies are published by the SFTA in a separate circular letter. In contrast to the circular letter for loans denominated in Swiss francs, there is only one safe haven interest rate per currency. Thus, no distinction is made between maximum interest rates (ie, for loans granted by shareholders and/or related parties) and minimum interest rates (ie, for loans granted to shareholders and/or related parties). However, in practice, the published safe haven interest rates for loans denominated in foreign currencies are considered as being minimum interest rates.

For instance, for the year 2019, the minimum interest rates for loans granted to shareholders or related parties denominated in euros or US dollars are as follows:

- Equity-financed loans: 0.75% (euros) and 3% (US dollars). However, in all cases, at least the safe haven interest rate on loans denominated in Swiss francs (0.25%) applies.
- Debt-financed loans: actual interest expense plus 0.5% with a minimum of 0.75% on loans denominated in euros and 3% on loans denominated in US dollars.

To determine the maximum interest rate for loans granted by shareholders and/or related parties, a spread (corresponding to the difference between the minimum and maximum interest rate for loans denominated in Swiss francs) is added to the published safe haven rate. For instance, the spread for loans granted by shareholders or related parties to a Swiss trading or production company is 2.75% (up to Sfr1 million) and 0.75% (above Sfr1 million) and the maximum interest rate for a respective loan denominated in euros is 3.5% (0.75% minimum interest rate plus spread) and 1.5% (0.75% minimum interest rate plus spread), respectively.

Proof of arm's length

The related parties may deviate from these safe haven rates and the Swiss company may therefore apply higher or lower interest rates to the extent that proof can be provided that the used rates are at arm's length. A loan is considered as being at arm's length if an independent third party would have granted such a loan under the same conditions.

Thin capitalisation rules

Loans from related parties

If down-stream or cross-stream loans are granted to a Swiss company by shareholders and/or related parties, the competent tax authority examines whether the Swiss company is not thinly capitalised (ie, excessively debt funded) from a tax perspective.

The tax practice regarding thin capitalisation is set out in a circular letter issued by the SFTA on 6 June 1997 which places a limit on the maximum amount of debt granted by related parties on which deductible interest payments are available. According to the circular letter, each asset category of the borrowing Swiss company must be financed by a certain equity portion (ie, the maximum underlying debt for each asset category is determined by a safe harbour debt-to-equity ratio (see table below)). The calculation is based on the fair market values of the underlying assets. For instance, participations in subsidiaries should be equity financed with at least 30%, which means that debt financing may amount up to 70% of the fair market value of the respective participations.

Maximum underlying debt by asset category

Cash and cash equivalents	100%
Accounts receivable	85%
Other receivables	85%
Inventories	85%
Other current assets	85%
Domestic and foreign bonds in Swiss francs	90%
Foreign bonds in foreign currency	80%
Listed domestic and foreign shares	60%
Non-listed domestic and foreign shares	50%
Participations	70%
Loan receivables	85%
Property and equipment	50%
Factory premises and plants	70%
Home property and construction land	70%
Other real estate	80%

Cost of constitution, increase of capital and organisation	0%
Goodwill	70%

As an exception therefrom, a safe haven debt-to-equity ratio of 6:1 applies to finance companies. Further, a Swiss company which is not in line with the safe haven rules may always prove that a higher debt is still at arm's length.

Third-party loans guaranteed by related parties

In general, Swiss thin capitalisation rules apply to related party loans only. Conversely, this means that debt financing of a Swiss company by independent third parties (eg, banks) is not restricted.

However, loans granted by independent third parties which are guaranteed by a shareholder or a related party of a Swiss group company are treated as loans from related parties under the Swiss thin capitalisation rules.

Tax consequences

If the funding of a Swiss group company does not comply with the safe haven interest rates and/or the Swiss thin capitalisation rules and no arm's length proof can be provided, the following tax consequences arise.

In case of thin capitalisation, the part of related party debt that exceeds the relevant debt-equity ratios determined in the circular letter is treated as equity subject to annual capital tax (hidden equity) and is not allowed to bear interest. Thus, the interest paid on the respective portion of hidden equity is re-qualified as a hidden dividend distribution. Excessive interest payments which are not in line with the safe haven rates published by the SFTA are equally treated (ie, are also re-characterised as a hidden dividend distribution). As a result, such interest is added back to the Swiss company's taxable income, which means that the tax deduction of interest paid on the hidden equity or in excess of the permitted safe haven rate is disallowed. Additionally, such hidden dividend distributions are subject to Swiss withholding tax at a rate of 35%.

In general, the Swiss withholding tax is refundable or creditable in full if the recipient of the hidden dividend distribution is a Swiss tax resident corporate or individual shareholder and certain requirements are met. Although Swiss withholding tax is generally conceptualised as a final tax burden for beneficiaries which are not Swiss resident for tax purposes, a full or partial refund may be available if the country in which such beneficiary is resident for tax purposes has entered into a double tax treaty with Switzerland.

In cross-border situations, where the beneficiary of the hidden dividend distribution is a corporate shareholder owning a qualifying participation in the Swiss company of usually 10%, the withholding tax is often reduced to 0%.

Relief at source (rather than a refund procedure) may be available provided that the application for the so-called 'notification procedure' has been filed and granted by the SFTA prior to the distribution of the hidden dividend. In this case, the cash outflow in connection with the Swiss withholding tax of 35% could be avoided by a timely notification of the hidden dividend distribution. However, if the lender is a related group company that does not own a qualifying participation in the Swiss company (eg, a sister company), the notification procedure cannot be applied and the 35% withholding tax is typically only reduced to 15%.

If a third-party loan is guaranteed by a related party and thus treated as a related-party loan for the purposes of the Swiss thin capitalisation rules, the Swiss company's direct shareholder is deemed to be the recipient of a potentially hidden dividend distribution, even though another related party may have guaranteed the loan. This SFTA practice is particularly favourable in a treaty context where a qualifying shareholder often benefits from a full refund of Swiss withholding tax.

Comment

In order to avoid adverse tax consequences associated with intra-group financing, it is crucial that the funding of a Swiss company by its related parties is in line with:

- the safe haven interest rates published annually by the SFTA; and
- the Swiss thin capitalisation rules.

Exceeding interest rates or debt ratios must comply with the arm's-length principle, which must be proven by the taxpayer. On the other hand, debt financing of a Swiss company by independent third parties is not restricted unless the respective loans are guaranteed by related parties of the Swiss company.

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