CORPORATE TAX - SWITZERLAND

Tax treatment of debt waivers and other debt-to-equity swaps

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Introduction

In economic life, debt waivers involving associated companies take on central significance in the context of a restructuring. It can be assumed that restructuring will greatly increase in the near future due to the financial difficulties of many companies resulting from the current COVID-19 crisis. Although the tax treatment of a debt waiver granted by an independent third party is essentially well defined (ie, it is recognised in income), many questions will arise if debt is waived by a related party – namely, a shareholder.

Debt waiver granted by a shareholder

Income tax

Under commercial and income tax law, a debt waiver granted by an independent third party indisputably leads to taxable income for the Swiss borrower. In accordance with the practice of the Swiss Federal Tax Administration (SFTA), debt waivers granted by shareholders must generally be treated in the same manner as third-party debt waivers.

The negative income tax consequences of the debt waiver in the event of a restructuring can at least be mitigated or even fully eliminated through extended set-off against losses. Debt waivers during a restructuring that are liable to income tax cannot be offset only against losses from the previous seven financial years but, by way of exception, also against losses from earlier periods.

However, in exceptional cases, debt waivers granted by shareholders are regarded as contributions to the equity of a Swiss subsidiary which are neutral in terms of income tax pursuant to the practice of the SFTA and the Swiss Federal Supreme Court (SFSC). Such cases are classified as 'spurious restructuring income'. The first type of spurious restructuring income is constituted by shareholder loans treated as hidden equity for tax purposes under the Swiss thin capitalisation rules prior to the restructuring. In accordance with the practice of the SFTA and the SFSC, another type of spurious restructuring income is a debt waiver relating to shareholder loans granted for the first time or on a subsequent occasion due to the Swiss subsidiary's poor results, which would not have been granted by an independent third party in comparable circumstances. In the event that one of these two types of spurious restructuring income is given, there will be no need to use up tax-loss carry-forwards and they may be offset against future profits.

Issuance stamp duty

A debt waiver granted by a (direct) shareholder represents a shareholder contribution subject to 1% issuance stamp duty – even if recognised in income.

However, no issuance stamp duty is payable provided that the one-off restructuring exemption of up to Sfr10 million can be exploited. This applies where the debt waiver is used to offset losses under commercial law. Where the conditions applicable to the restructuring exemption are not (or only partially) met and the exemption threshold of Sfr10 million is exceeded, respectively, the company may request an abatement of the issuance stamp duty from the SFTA.

In this context, a debt waiver will be subject only to issuance stamp duty if the waiver-creditor is a direct shareholder of the debtor (ie, they hold shares or participation and dividend right certificates, respectively). If the waiver-creditor is simply an indirect shareholder (eg, a grandparent company), *a priori* no issuance stamp duty will be payable.

AUTHORS

Maurus Winzap

Fabienne Limacher

Formation of capital contributions reserves

As a debt waiver constitutes a contribution, at least in economic terms and from a stamp duty issuance standpoint, the question arises of whether this establishes an entitlement to form capital contributions reserves (CCR) which can later be paid back to the shareholders without 35% Swiss withholding tax being charged.

No CCR may be constituted for a debt waiver recognised as income under commercial law. CCR can therefore only be constituted from a debt waiver by a direct shareholder if they are not exceptionally recognised as income under commercial law and are not offset against losses. Accordingly, as the restructuring exemption of up to Sfr10 million for issuance stamp purposes will be available only if losses are offset, the Swiss subsidiary must choose between relief from issuance stamp duty and the creation of CCR.

Other debt-to-equity swaps

Although a shareholder debt waiver appears as an especially straightforward means of balance-sheet restructuring from a legal standpoint, it holds little attraction in profit tax terms due to the previously described, current practice of the SFTA and the SFSC. Fortunately, a well-advised taxpayer can avoid the income tax consequences arising out of a debt waiver through a simple modification of the legal course of action.

Cash contribution with loan repayment

The simplest way to achieve neutral treatment in terms of income tax is the so-called 'cash merry-go-round' in which a creditor makes a cash contribution to the debtor in the nominal value of the debt. The latter repays the debt with the funds received. Such a contribution is clearly neutral in terms of income tax.

Contribution of loans receivable

If a direct or indirect shareholder makes a contribution of loans receivable to the direct or indirect debtor subsidiary in the form of a non-cash contribution (as a contribution in kind), this should represent an *à fonds perdu* contribution. In legal terms, debt is not extinguished on account of the claim being waived (subject to income tax), but on account of the confusion of debtor and creditor resulting from the contribution. The contribution of the loans receivable into the reserves is therefore exempt from income tax.

As an alternative to contributing the loan receivables, the direct or indirect shareholder as creditor of the existing loans receivable may decide to make a contribution in the same amount to the direct or indirect subsidiary, thus constituting a new claim of the subsidiary regarding the direct or indirect shareholder. As a second step, the subsidiary declares its liability to be offset against the new claim resulting from the contribution undertaking.

Set-off against a claim in the context of a capital increase

Instead of a contribution without a capital increase, the debt may be used as set-off against a claim in the context of a capital increase by the subsidiary. Set-off against a claim constitutes a disclosed capital investment by the shareholder involving a neutral recognition by the company and the shareholder rather than a waiver. The debt concerned is fully recognised as equity by the subsidiary. This procedure also represents a contribution with a neutral impact on income tax.

Comment

The tax situation of a Swiss loss-making subsidiary and its direct or indirect shareholders differs considerably depending on the specific restructuring measures taken by the related parties. In particular, in the event of debt waivers, the Swiss debtor's tax-loss carry forwards may be used up and can no longer be offset against future profits. Against this background, it is key that the potential tax consequences are analysed in detail and, if need be, alternative debt-to-equity swaps will be taken into consideration before such restructuring measures are implemented.

For further information on this topic please contact Maurus Winzap or Fabienne Limacher at Walder Wyss by telephone (+41 58 658 58 58) or email (maurus.winzap@walderwyss.com or fabienne.limacher@walderwyss.com). The Walder Wyss website can be accessed at www.walderwyss.com.
