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What is the latest news on the Swiss withholding tax reform?

*The Swiss government has issued a legislative proposal for a reform of the Swiss federal withholding tax regime. **Nils Harbeke** looks at the finer detail of the proposals below.*

Switzerland is planning to introduce a legal basis to levy a 35 per cent withholding tax on manufactured payments which occur in securities lending transactions. The tax would apply to the extent the underlying original payment is subject to Swiss withholding tax.

Further, Switzerland is planning to exempt certain groups of investors from the withholding tax on interest from bonds (including certain syndicated loans) and credit balances at banks in Switzerland. Specifically, a withholding tax exemption shall apply to investors tax resident outside Switzerland as well as investors in the form of a body corporate in Switzerland. These exemptions would equally apply to manufactured payments of interest.

As an additional measure, there is a proposal to abolish the Swiss securities transfer tax on bonds issued by issuers in Switzerland.

Swiss withholding tax on interest

In contrast to other countries, Switzerland levies withholding tax on interest only in certain cases:

- From bonds issued by issuers in Switzerland;
- From credit balances at banks in Switzerland; and
- From loan receivables of creditors outside Switzerland against borrowers in Switzerland, which are secured by security interests in Swiss real property.

Interest on loans is not generally subject to Swiss withholding tax. By way of exception, interest on loans is subject to Swiss withholding tax:

- If a bank in Switzerland owes interest to a creditor which is not a bank; or
- If the loan is re-characterised as a “bond-like” instrument according to the so-called Swiss 10/20 Non-Bank Rules.

The Swiss 10/20 Non-Bank Rules are relevant, in particular, if a loan is syndicated. For the purposes of Swiss tax law, a loan may be deemed a “bond” such that Swiss withholding tax is levied on the interest as soon as there are more than

10 creditors under the same debt instrument who are not banks (Swiss 10 Non-Bank Rule). Also, a loan may be deemed a “bond” for the purposes of Swiss tax law if the Swiss debtor has more than 20 relevant creditors in total who are not banks (Swiss 20 Non-Bank Rule). There are exceptions for intra-group creditors.

Why a withholding tax reform?

On the international capital market, bonds can usually be placed only under the usual conditions if the interest is not subject to deduction of tax at source. The Swiss government would like to reach a point where fewer issues occur abroad and more issues occur in Switzerland so that the added value and jobs associated with this issuing of bonds remain in Switzerland.

The planned changes may also facilitate loan syndication. This will be the case to the extent that practicable ways to exempt interest from withholding tax emerge where a loan is re-characterised as a “bond” under the Swiss Non-Bank Rules.

For the proposed rules on withholding tax on manufactured payments, the introduction of these rules is unrelated to the plans to change the interest withholding tax regime. The introduction of a legal basis for levying withholding tax on manufactured payments is planned because the Swiss Federal Supreme Court had decided that the former practice of the Swiss tax authorities to require withholding tax be levied on manufactured payments did not have a sufficient legal basis.

What are the planned changes regarding interest withholding tax?

Investors who are tax resident outside Switzerland and investors in the form of a body corporate resident in Switzerland shall be exempt from withholding tax on interest, in particular interest from bonds.

Furthermore, the paying agent in Switzerland – rather than the Swiss debtor of the interest-bearing instrument – will levy a withholding tax on the interest income. This switch in levying responsibility is a genuine system change as regards the levying of Swiss interest withholding

tax, namely from the debtor principle to the paying agent principle.

This, however, will include only interest income of beneficial owners who are natural persons and tax resident in Switzerland. At the same time, interest income will now be included, regardless of the interest debtor's domicile (Switzerland or other countries). The main difference between the debtor and paying agent principles is that, under the debtor principle, withholding tax can be levied only on interest accruing on a debt instrument that a debtor resident in Switzerland issues, whereas, under the paying agent principle, Switzerland is also able to levy withholding tax on interest owed on securities issued outside Switzerland.

The current legislative proposal suggests that application of the paying agent principle shall be voluntary for interest payable on, in particular, bonds provided by issuers in Switzerland (including loans re-characterised as bonds under the Swiss Non-Bank Rules, but excluding structured products). This choice shall be available whether or not the Swiss debtor of the interest-bearing instrument and the paying agent is the same entity. Where the paying agent principle is not applied, the Swiss debtor of the interest-bearing instrument must withhold tax from all interest payable, ie the tax exemptions for investors residing outside Switzerland as well as investors residing in Switzerland in the form of a body corporate are available only if the paying agent principle rules are applied. Thus, in syndicated lending, lenders may want to consider easing the usual contractual syndication restrictions addressing the Swiss Non-Bank Rules by requiring the borrower to apply the paying agent principle to the extent such an approach makes it unnecessary to rely on syndication restrictions to work around application of Swiss withholding tax.

The tax rate will remain unchanged at 35 per cent.

For paying agent tax to be levied on interest in the future, the following requirements must therefore be met:

- There must be an income item classed as relevant “interest” income;
- A paying agent in Switzerland must be involved; and
- The beneficial owner must be a natural person with tax residence in Switzerland.

If the paying agent is located outside Switzerland, then the automatic exchange of information (AIA) legislation applies.

No changes are envisaged to withholding tax on interest from loan receivables of creditors outside Switzerland against borrowers in Switzerland, where Swiss withholding tax is triggered only because the loan receivables are secured by security interests in Swiss real property.

Also, with the exception of manufactured payments, no changes are envisaged to investment income (ie income

from dividend distributions), to which the debtor principle will continue to apply. For manufactured payments, the paying agent principle will apply, with the paying agent required to withhold the tax being the Swiss paying agent of the debtor of the manufactured payment (or, where no external paying agent is involved, the debtor of the manufactured payment).

The following questions in particular come up in relation to a changeover to the paying agent principle for interest income.

When is income classed as relevant interest income?

The paying agent tax will apply not only to classic direct interest income (“% x directly held reference value”) but also to so-called “indirect” interest income. In particular, income deriving from structured products or from investment fund units could be affected by the interest withholding tax as “indirect” interest.

As regards investment funds, from the perspective of natural persons resident in Switzerland as investors in fiscally transparent funds, the question already exists whether the fund income was derived from capital gains (then the investor is exempt from income tax for that income) or from other sources (on which the fund investor is liable for income tax). Current fund reporting rules do not, however, require that interest income be carved out from other taxable income such as, for example, dividend income.

Is the beneficial owner a natural person?

Parallels may be drawn with the previous EU/Switzerland agreement on the taxation of interest (since replaced by the AIA). The EU/Switzerland agreement on the taxation of interest applied to interest income whose beneficial owner was a natural person (resident in the EU).

To simplify paying agent-based taxation procedures, the legislative proposal suggests that it is the legal nature of the paying agent's contractual counterparty that will determine whether or not an investor-related tax exemption applies. As a rule, paying agent tax shall be triggered only if the counterparty is a natural person. For partnerships (treated transparent for Swiss income tax purposes), paying agent tax shall be triggered for Swiss tax resident natural persons in the partnership, unless the partnership is required by law to maintain statutory accounts in Switzerland. Private wealth managers, service providers acting under fiduciary arrangements or trustees may qualify as paying agents themselves, thereby being required to withhold the tax.

Who is a Swiss paying agent?

In the paying agent tax system, the paying agent obliged to levying the tax must be legally defined. Again, this subject is not entirely new and, in fact, similar

questions were asked when the previous EU/Switzerland agreement on the taxation of interest was in force. Only a paying agent in Switzerland will be required to withhold tax. In paying agent to paying agent transactions, only the paying agent holding the relationship with the ultimate investor is required to make the withholding.

Banks are affected if the customer is booked in Switzerland. Also private wealth managers, service providers acting under fiduciary arrangements or trustees may qualify as paying agents.

In special situations, the debtor of the interest-bearing instrument and the paying agent may be the same entity. This situation may, for example, occur, where small or medium-sized enterprises issue taxable bonds that are not held in third-party custody, or where a loan is re-characterised as a bond under the Swiss Non-Bank-Rules.

What happens when there is no (full) cash payment for interest income?

On occasion, despite (“indirect”) interest income, there may not be a (complete) corresponding payment flow (from the instrument) to the investor who is the beneficial owner. In particular, this situation may occur with fiscally transparent accumulation investment funds. The legislative proposal specifies that it shall be the paying agent’s responsibility to put in place safeguards on a contractual basis in order for the paying agent to be able to recover the tax owed by the paying agent.

How is the tax assessment basis determined?

The question arises how to determine the assessment basis for the paying agent’s tax withholding and becomes especially relevant if interest income from sources outside of Switzerland is subject to withholding tax under local foreign tax law. The legislative proposal specifies that the

gross interest will be the basis for levying the Swiss paying agent tax with, however, a possibility of crediting non-refundable foreign source taxes against the Swiss paying agent tax.

Where products such as investment funds, structured products, etc are concerned, the paying agents would need to have up-to-date information from the parties issuing the products.

What liability risks are associated with collecting the tax?

It is planned that the paying agent will be responsible for correct collection and timely payment of the tax. Criminal liability would arise only in the event of intent.

Outlook – next steps

Upon entry into force, the new withholding tax rules would not only apply to newly issued debt instruments but also to debt instruments issued under the current withholding tax regime. The Swiss government believes that the tax reform will likely not be implemented before 2023. The consultation procedure is open until 8 July 2020 and parliamentary debates are not expected before 2021. The current legislative proposals may be changed as a result of these procedures. The changeover to the paying agent principle does, however, mean that customers must be newly classified and that paying agents’ IT systems must be adapted. And before any IT programming can be made, a necessary assessment of both what relevant interest is, as well as who the paying agent is, must be performed. Therefore, further developments to the reform will need to be monitored closely.

Nils Harbeke is a partner and head of the Tax Practice Group at Pestalozzi Attorneys at Law Ltd (www.pestalozzilaw.com/en/) in Zurich. He can be contacted at nils.harbeke@pestalozzilaw.com.

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Client Services: Please contact Client Services on tel: +44 (0)20 3377 3996; +65 6508 2430 (APAC Singapore), or email clientservices@i-law.com

Editorial queries: Please contact Kate Clifton on tel: +44 (0)20 3377 3976, or email kate.clifton@informa.com

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Print managed by: Paragon Customer Communications.

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