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Applying Swiss interest rates to advances or loans in 2022

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Applying Swiss interest rates to advances or loans in 2022

Peter von Burg and **Rolf Wüthrich** of **burckhardt** discuss interest rates applicable to advances or loans in Switzerland and consider the consequences of non-compliance.



As every year, the Swiss Federal Tax Administration (FTA) published a circular with the interest rates recognised for tax purposes for advances or loans in relation to equity holders or related parties in Swiss francs or foreign currencies.

These interest rates are applicable for the calendar year 2022, regardless of whether a business year with a closing date other than December 31 is kept or whether a loan was granted long before 2022.

In practice, the application of the correct interest rate is of high importance, in particular because excessive interest that is paid to related parties abroad, for example to shareholders or sister companies, is qualified as a deemed dividend which is subject to Swiss withholding tax at the rate of 35%.

The interest rates published by the FTA are not legally binding, as they are not formally enacted in a statute. In practice, however, the interest rates are considered as safe harbour interest rates. In other words, the interest rates are considered to pass an arm's-length test and do not need to be further justified.

In case of related international companies or foreign equity holders, it should be checked of course as to whether a third-party comparison is complied with from the point of view of the relevant foreign tax authorities.

Interest rates vary significantly depending on who is granting an advance or loan and the currency in which these loans are granted. Since interest rates change annually and the calculation is complex, the interest setting in loan agreements should preferably be designed dynamically.

This means that the applicable interest rate should adjust on a yearly basis to the interest rates permitted by Swiss and foreign tax law to avoid – in an environment of decreasing interest rates – unexpected Swiss withholding tax consequence on long-term loans.

Advances or loans to equity holders or related parties (in Swiss francs)

The interest rate for advances or loans to equity holders or related parties in Swiss francs depends on how the advance or loan to related parties was sourced. If the advance or loan is financed from equity and there are no interest-bearing liabilities, the applicable interest rate is at least 0.25%.

If the company itself has to pay interest on the granted loan, the minimum interest rate to be applied to the equity holder must be at least 0.5% more than the interest paid by the company, which applies to an advance or loan up to and including CHF 10 million (approx. \$10.8 million).

If an advance or loan exceeds the amount of CHF 10 million, a margin on the interest rate of at least 0.25% must be applied to this part. For example, if a loan of CHF 20 million is financed with borrowed funds at an interest rate of 0.25%, the following applies: The loan must be interest-bearing with at least 0.75% on CHF 10 million (= CHF 75,000) and at least 0.5% on the other CHF 10 million (= CHF 50,000), i.e. a total of CHF 125,000 or an average interest rate of 0.625%.

The reason for the minimum interest rates is that a shareholder or related party should not receive a loan without compensation. The FTA argues that a company would hardly ever grant a loan to an independent third party without interest and collateral. In today's interest rate environment with negative interest rates, this interest rate applied by the FTA seems rather high. Nevertheless, the practice of the FTA is consistent and cannot be ignored without risk.

As mentioned above, a deemed dividend occurs if the company does not pay interest at all or does not pay sufficient interest on the loan granted.

In addition, caution is required in the case of loans to equity holders or related parties, as these are often not secured in practice and, particularly in the case of substantial loans, the tax administration and also case law refer to simulated loans, which can qualify entirely as a deemed dividend or hidden profit distribution (see below for tax consequences). Such a loan may be deemed to exist if repayment was not possible or a repayment was not intended as from the beginning on.

Advances or loans from equity holders or related third parties (in Swiss francs)

The amount of the interest rate for advances or loans from equity holders or related third parties in Swiss francs to Swiss companies depends on how the advance or loan will be used. A distinction is made as to whether the funds are used for the financing of real estate or for business operations. For example, the maximum interest rate is 1.5% for a loan in the amount of the first mortgage of a commercial property, i.e. up to two-thirds of the market value of this property.

In practice, loans for business operations are frequently found. In the case of trading or manufacturing companies,

loans up to CHF 1 million may bear interest at a maximum rate of 3%. If a loan exceeds the amount of CHF 1 million, an interest rate of maximum 1% may be applied to the exceeding part. The interest rates for holding and asset management companies are lower, namely loans up to CHF 1 million may be subject to a maximum interest rate of 2.5%. If a loan to a for holding or asset management company exceeds the amount of CHF 1 million, an interest rate of maximum 0.75% may be applied to the exceeding part.

Interest paid on equity holder (or related party) loans which are economically considered as hidden equity capital is not deductible for corporate income tax purposes and may face withholding taxes consequences (see below for details).

The FTA has issued guidelines which clarify the accepted debt/equity ratio and the calculation mechanism of hidden equity. These guidelines state that a company must not have a debt that exceeds certain percentages of the market value of its assets. Normally, the year-end financial statements serve as basis for the calculation of the hidden equity. For example, the equity expected for the financing of participations is at least 30% which means that the debt may be up to 70%.

If a Swiss company has debt in excess of the amount resulting from the valuation on the basis of these percentages, then the company is deemed to be thinly capitalised. In such a case the excess amount will be requalified in hidden equity and will be subject to the cantonal capital tax. As mentioned before, the interest paid on hidden equity will be added to the taxable profit.

In particular, it should be noted that the FTA also includes loans guaranteed by the shareholder or related party in the calculation of hidden equity. This may significantly change the calculation of accepted interest and tax consequences accordingly although it is reasonable for a taxpayer to take the position that, despite the guarantee, a third-party comparison and therefore a third-party interest rate is still complied with.

The interest rates above the threshold of CHF 1 million are based on long-term industrial investments, in particular bonds. For the calculation of interest, the loans of all equity holders and related parties must be aggregated. However, it is up to the company to decide which of the lenders it would like to grant the higher interest rate on the first CHF 1 million. Therefore, in the case of several loans, it may well be that one equity holder receives a higher interest rate than the other equity holder.

Interest paid to independent third parties at rates deviating from the FTA rates is of course deductible as it reflects an arm's-length price. The circular also expressly states that interest at deviating rates may be charged in the case of shareholders or related parties, provided that the third-party comparison can be demonstrated.

In practice, such proof of an arm's-length rate deviating from the rates published by the FTA is usually rather difficult



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After completing his commercial training, Peter studied business law at the Zurich University of Applied Sciences and completed his master's degree in law at the University of Lucerne in 2012. He completed internships at a large auditing firm, at a renowned commercial law firm and at a civil court and was admitted to the bar in 2014.



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and the FTA is reluctant to admit it. This may be feasible where a shareholder redeems a previous debt to an independent third party and the same interest rate continues to be applied. However, the question then arises as to how long the third-party comparison will be complied with. In our opinion, this can be assumed to be the case as long as market interest rates do not change significantly.

Finally, one might ask whether minimum interest rates apply to advances or loans from equity holders. Neither Swiss legislation nor the circular issued by the FTA preview a minimum interest rate to be levied by shareholders loans granted to subsidiaries. Thus, in practice such loans often do not bear any interest.

Advances or loans to equity holders or related parties (in a foreign currency)

In its circular, the FTA publishes a chart with the most common foreign currencies. For example, the minimum interest rate for 2022 for loans in euros to equity holders or related parties is 0.5% (previous year 0.25%) and for US dollars 2% (previous year 1.25%).

The variation can be significant depending on the currency, for example the interest rate for Brazilian real

(BRL) is 11.25% (previous year 5.75%) or Danish kroner (DKK) 0.5% (previous year 0.5%). If the interest rate of the foreign currency is lower than the interest rate according to the circular in Swiss francs, at least the corresponding interest rate for Swiss francs has to be taken into account.

These interest rates are applicable to advances or loans to equity holders or related third parties if they are funded from equity. If the company has entered into interest-bearing liabilities, advances or loans to equity holders or related third parties shall bear interest to the extent of the interest-bearing liabilities at the borrowing rates including any fees plus a surcharge of 0.5%, but at least at the interest rates specified in the circular.

Advances or loans from equity holders or related third parties (in a foreign currency)

For advances or loans to equity holders or related third parties in a foreign currency, a maximum interest rate must be calculated. In this case, a surcharge equal to the difference between the minimum and maximum interest rate in Swiss francs may be added to the published foreign currency rate (so-called spread). The circular concerning loans in foreign

currency is less intuitive, as it does not indicate the specific interest rates to be applied depending on the situation.

In practical terms, this means that the surcharge (spread) for business operation loans to a trading or company up to an equivalent value of CHF 1 million is 2.75% (3.00% less 0.25%). For example, if the loan received by a manufacturing company amounts to EUR 900,000 (exchange rate = 1.11 = CHF 1 million), this may be subject to a maximum interest rate of 3.25% (0.5% for foreign currency Euro plus 2.75% surcharge).

For a loan in US dollars, which according to the exchange rate amounts to a maximum of CHF 1 million, the maximum admissible interest rate would thus be 4.75% (2% plus 2.75%). In practice, the above-mentioned surcharge or spread is often not taken into account in the applicable interest rate. However, according to the FTA, a company cannot retroactively apply such 'forgotten' surcharges in subsequent years, i.e. in different tax periods.

Also for foreign currency loans it is possible to claim higher interest on the basis of the third-party comparison. As mentioned above, such a proof is usually rather difficult. In addition, business reasons must be provided to show why a liability has not been concluded in in lower-interest bearing Swiss francs.

Finally, interest paid on equity holder (or related party) loans which are economically considered as hidden equity capital are not deductible (see above for details).

Tax consequences for non-compliance with interest rates

The Swiss tax authorities regularly check whether the interest rates applied by a Swiss company meet third-party comparisons. If the tax authorities determine that this is not the case, there are usually a number of relevant administrative, tax and sometimes criminal consequences.

Excessive interest payments, for example to a foreign parent company, qualify as so-called hidden profit distributions (or deemed dividend), which are subject to Swiss withholding tax of 35%.

The Swiss withholding tax requires that the tax is borne by the recipient. More specifically, in practice, when interest is

being adjusted, 35% of the taxable amount (adjusted interest) must be paid back by the dividend recipient (e.g. parent company) to the dividend payer (e.g. subsidiary), so that the latter can remit the withholding tax in the amount of 35% to the FTA. If this does not happen – for example, due to liquidity reasons or a gross-up clause in the loan agreement – then according to the FTA, the dividend received is already reduced from the perspective of the dividend recipient, i.e. 65%, which means that the withholding tax to be remitted must be grossed up on this basis and in fact amounts to 53.8%.

Fortunately, Switzerland has concluded double taxation agreements with many jurisdictions, which means that in some cases the remittance of withholding tax can be (partially) reported and does not have to be remitted if all formalities and requirements are met (notification procedure in case of direct shareholder).

In other cases, the recipient of the dividend may be entitled to apply for a (partial) refund on the basis of the applicable double taxation agreement. A refund requires the payment of the withholding tax and the submission of the correct forms within the deadline.

As the requalification of excessive interest payments into a deemed dividend normally occurs only in the course of a tax audit, which takes place some years after the requalified interest payment took place, interest for late payment of the withholding tax is due at a rate of 5%. In a withholding tax audit normally the last five years are reviewed; in case of the opening of a criminal procedure seven years can be audited and be reassessed.

In addition, the excessive interest is added to the taxable profit of the Swiss company. Such adjustments for corporate income tax purposes can be pursued for up to 10 years. Furthermore, interest on late payments may be incurred. Finally, criminal tax proceedings and criminal proceedings may be opened leading in long-lasting procedures against the persons in charge, be it executives, board members and/or its employees in charge of a certain function, resulting in high advisory costs and fines for the responsible individuals.

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