

Leveraged takeovers in Switzerland

Alberto Lissi and Ursula Wechner of Taxpartner

– Taxand look at the qualification of debt financing for Swiss withholding tax purposes, and the tax implications of the syndication of the debt and securities in highly leveraged takeovers.

The appetite for Swiss targets has been significant over the last few years. Takeover situations regularly involve financial leverage and tax efficient structuring of interest and amortisation duties. The acquiring company is usually a leveraged special purpose vehicle (SPV) resident either in Switzerland or outside of Switzerland. The debt is often furnished by financial institutions and institutional investors.

Leveraged buyout: Types of financing instruments

Financial institutions and institutional investors provide for a wide range of debt financing instruments. In takeovers, these instruments are often used in parallel.

Senior debt is first ranking debt which is in general used for the purpose of the acquisition of the target and is therefore granted to the SPV. Senior debt generally has a term of five to nine years and is often split into several tranches (Senior A, B, C etcetera) which can be distinguished with regard to their term and the lenders. Senior debt is often syndicated to banks (Senior A tranches) or to institutional investors (Senior B, C etcetera tranches). The main goal of syndicated lending is to spread the risk of a borrower default across multiple lenders (such as banks) or institutional investors like pensions funds and hedge funds. Syndicated loans are often used in the leveraged buyout community to fund leveraged corporate takeovers. Typically there is a lead bank or underwriter of the loan, known as the agent. This lender may be putting up a proportionally larger share of the loan, or perform duties like dispersing cash flows among the other syndicate members and administrative tasks. Revolving credit facilities are conceptually close to the Senior A debt but are used as working capital for the target, therefore they are not granted to the SPV but to the target itself.

Mezzanine, or junior capital financing is the portion of a company's capital that sits between senior debt and common equity in the form of subordinated debt, preferred equity, or some combination of these two securities. It is generally subordinated to senior debt in terms of payment priority but senior to common equity and generally has a term of eight to 12 years. Junior capital is typically unsecured and commands a higher yield than senior debt.

Another form of second lien financing are high yield bonds. These are high paying bonds with a lower credit rating and typical returns range from the mid-to-high teens.

Definition of “bond” according to Swiss withholding tax

Every international business lawyer involved in negotiating syndicated lendings in which Swiss borrowers are a party will have come across the 10 non-bank lender rule and the 20 non-bank lender rule.

Interest payments made by a Swiss tax resident borrower under an individual loan agreement are generally not subject to Swiss withholding tax. However, interest payments on a bond issued by a Swiss issuer are subject to a 35% Swiss withholding tax.

A loan is considered a bond if a Swiss borrower borrows money exceeding CHF500,000 (\$534,000) from more than 10 non-bank lenders under identical conditions. If the conditions of a loan that exceeds CHF500,000 are not identical (but similar) and if the loan is granted by more than 20 non-bank lenders, then a loan is considered a cash bond.

Under guidelines issued by the federal tax authorities, a syndicated loan is treated as a bond if

(i) a Swiss tax resident borrower of one syndicated facility (providing for identical conditions) owes interest-bearing money of more than CHF500,000 to more than 10 lenders which are not banks (10 non-bank lender rule) or (ii) a Swiss tax resident borrower under debt relationships with different conditions owes interest-bearing money of more than CHF500,000 to more than 20 lenders which are not banks (20 non-bank lender rule).

Interest on customer balances is subject to Swiss withholding tax as soon as the number of depositors exceeds 100 and the total debt amounts to at least CHF5 million. In the case of syndicated loans, the lenders are not considered to be depositors as they are granting a loan to the SPV for the purpose of the transaction. In addition, the syndicated loan is split into fixed amounts and the customer balances are not.

As an exception, intra-group lenders do not count as lenders under these rules provided that the Swiss borrower does guarantee neither a foreign bond issued by a foreign group entity nor a bond-like syndicated lending of such foreign group entity (that is where more than 10 non-bank lenders grant funds to the foreign group entity).

Interest paid on a bond or cash bond issued by a non-Swiss issuer is subject to Swiss withholding tax of 35% if the bond is guaranteed by a Swiss company and the funds raised are directly or indirectly made available to a Swiss group company. Based on the current practice of the federal tax authorities, a harmful guarantee is assumed if it is issued by the Swiss parent company in favour of a foreign company issuing the bond. In the case of leveraged buyouts, the guarantees granted – within the limitation of Swiss commercial law – by the target Swiss company (upstream-guarantees). Such upstream-guarantees are basically not considered harmful for the qualification of bonds.

Qualification of financing instruments for Swiss withholding tax purposes

The withholding tax treatment on interest of bonds, according to Swiss tax practice, must be adequately considered when structuring the financing of leveraged takeovers in Switzerland.

Biography



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Alberto Lissi is one of 11 partners at Tax Partner – Taxand, the Swiss leading independent firm of tax advisers. He has a Ph.D. in international taxation and more than 14 years' experience of Swiss and international tax.

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In syndicated loans, several lenders grant a loan, based on a single credit facility agreement (umbrella agreement). Individual loan agreements may be added to this umbrella agreement. The lenders therefore generate a syndicate or consortium. Such syndicated loan facility is a closed financial contract in which each lender participates at identical conditions. Each lender participates with a certain quota at the total credit facility and lends the amount directly to the borrower. Therefore, such syndicated loans qualify as bonds from a Swiss perspective if the lenders consist of more than 10 non-banks.

In case of a sub-participation, the sub-participant is not in a direct legal relationship with the borrower. Sub-participations are often granted by members of a consortium of a syndicated loan to third parties and their only legal relationship is a contract with a lender of the syndicate. Therefore, a sub-participant basically does not count for the 10/20 non-bank lender rule with regard to the ultimate borrower but it may count for the 10/20 non-bank lender rule of the member of the consortium.

Different from the sub-participation is the assignment of (parts of) loans by a lender of the syndicate to another party, that implies a change of the party (lender) in a credit facility agreement. In general new lenders count as parties for the 10/20 non-bank lender rule as they step into the original contract and have a direct claim against the borrower.

In this regard, to avoid withholding tax consequences, it is important to include appropriate clauses in the credit facility agreements. A carefully drafted agreement typically provides limitations with regard to the identity of the lenders and foresees that each transfer requires the consent of the Swiss bor-

Biography



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Ursula Wechner is a senior adviser of Tax Partner – Taxand, the leading independent Swiss firm of tax advisers. She has more than 20 years' experience in Swiss and international tax law.

Ursula, whose native language is German and who is fluent in English, has specialised in advising international and national corporate clients with regard to group structuring, restructuring and financing issues. She also specialises in international corporate tax planning and structuring, the performing of tax due diligences and the handling of regular/current tax issues of Swiss entities.

rower. Assignments are typically only accepted as long as the syndicate does not lead to more than 10 non-bank lenders under the agreement and overall not more than 20 non-bank lenders of the Swiss borrower.

Financing of interest and amortisation duties

As the leverage portion of the purchase price triggers interest payments, proceeds need to be generated to enable the SPV to service such interest and amortisation duties. A typical question to be addressed is the following: How can the Swiss target and the target's operating subsidiaries participate in serving such payment duties? Basically, the desired effects can be achieved by dividend payments, granting of loans, redemption of equity and mergers.

Dividends and similar cash or in-kind distributions of the Swiss target are subject to Swiss withholding tax imposed on the gross amount at a rate of 35%. The withholding tax is usually fully reduced at source or refundable in full to a Swiss resident recipient. Non-Swiss resident beneficiaries of such distributions may be entitled to a partial or full refund of the withholding tax in accordance with the Swiss–EU agreement on savings taxation or any applicable double tax treaty between Switzerland and the country where the beneficiary is tax resident. As an example: Assuming the beneficiary (SPV) is resident in Luxembourg, in this case the double tax treaty between Switzerland and Luxembourg provides for the full refund/reduction of withholding tax only after a holding period of two years. Therefore, other solutions than dividend

distributions are to be found for payments during the first two years of holding.

Loans from a Swiss company to the parent company are often used to pay liabilities resulting from the acquisition during this waiting period. However, such upstream loans are subject to limits from a Swiss commercial law perspective. The cash flow of the target may only be lent to the parent company to the extent the target has distributable equity. In addition, several legal criteria must be met when granting upstream loans.

As an alternative, a target's nominal share capital can be reduced or qualifying capital contribution reserves – which are free of Swiss withholding tax – can be distributed to the SPV to repay debt or pay interest. The nominal capital cannot be reduced below the minimum share capital according to Swiss commercial law. Furthermore, a lengthy legal procedure, which likely requires three to six months, needs to be taken into account. Distributions out of capital contribution reserves require the same legal procedure as normal dividend distributions, that is the approval of the shareholder(s) only. It may be advisable to create such capital contribution reserves by appropriate reorganisation measures when structuring the acquisition.

A statutory merger among SPV and target is usually tax neutral for the companies involved. Interest cost in the target generated by a debt push-down merger are, however, generally not accepted to be tax deductible in Switzerland.

Future developments

In 2011, the Federal Council proposed fundamental changes to Swiss withholding tax regulations in relation to interest payments on bonds and debentures. The aim of the proposed regulations was to change the withholding tax system for interest paid on bonds and debentures by switching from the debtor principle to the paying agent principle. Furthermore, according to the contemplated changes, Swiss corporate investors and non-Swiss resident investors would, in general, be excluded from the scope of Swiss withholding tax. On the other hand it was intended to broaden the scope of Swiss withholding tax with regard to Swiss resident individual investors, by imposing Swiss withholding tax on bonds and debentures issued by foreign issuers. Such legislative changes would have had a massive impact on the structuring of Swiss takeover financing.

In 2012, the Swiss Parliament returned the legislative proposal to the Federal Council for further analysis and consideration of the latest developments in international tax law (final withholding tax agreements between Switzerland and single countries, revision of the European savings directive, the US Foreign Account Tax Compliance Act). A working group at federal and cantonal level is elaborating a new draft report and amended regulation which shall be submitted to the Federal Council for further political discussion in December 2013.

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