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Interest Limitation Rules (BEPS Action 4 / ATAD)

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Interest Limitation Rules (BEPS Action 4 / ATAD)

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Abstract

This thesis examines whether the OECD/G20 BEPS Action 4 and the EU Anti-Tax Avoidance Directive have impacted Switzerland's domestic thin capitalisation rules as well as how such thin capitalisation rules should be designed from a tax policy perspective. Regarding the first aspect, Switzerland has not adopted and, as far as it can be observed, has not intended to adopt any change to its current thin capitalisation rules to be in line with the international developments. Regarding the second aspect, the author is of the opinion that Switzerland should not introduce an interest limitation rule pursuant to the OECD/G20 recommended approach. Indeed, such a rule would restrict the freedom of financing, reduce legal certainty, harm the attractiveness of Switzerland and have only limited effects on fighting BEPS. According to the Swiss safe haven practice, the tax authorities assume excessive debt capital to the extent that the debt originating from shareholders or persons related to them exceeds the admissible debt capital calculated with given asset/debt ratios. The author shows that such practice is not in line with the legal wording of the Swiss thin capitalisation rules. Following a *substance over form* approach, the relevant articles require from the debt capital to have the economic functions of equity to justify a tax reclassification as deemed equity. Therefore, in order to achieve compliance, the author proposes to implement the current practice in the law *de lege ferenda*.

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Abbreviations

AEOI CH-EU	Agreement between Switzerland and the EU on the automatic exchange of information on financial accounts (SR 0.641.926.81)
aFTHA	Federal Act on the Harmonisation of direct cantonal and communal Taxes (*Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden*, version as of July 1, 2019)
AJP	Current Legal Practice (Review) (*Aktuelle Juristische Praxis*)
Art.	Article
ASA	Archive for Swiss Tax Law (Review) (*Archiv für Schweizerisches Abgaberecht)*
ATAD	Council Directive (EU) 2016/1164 of 12 July, 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market
BEPS	Base Erosion and Profit Shifting
BIT	Bulletin for International Taxation
BSK	Basel Commentary (*Basler Kommentar*)
C-ZH	Constitution of the Canton of Zurich (*Verfassung des Kantons Zürich*, ZH-Lex 101)
CFC	Controlled Foreign Company
CHF	Swiss franc
cit.	cited
CO	Code of Obligations (*Bundesgesetz betreffend die Ergänzung des Schweizerischen Zivilgesetzbuches, Fünfter Teil: Obligationenrecht*, SR 220)
cons.	consideration
CR	*Romand* Commentary (*Commentaire romand*)
Diss.	Dissertation thesis
DStR	German Tax Law (*Deutsches Steuerrecht*)
DTA	Double Taxation Agreement
DTA CH-A	Double Taxation Convention Switzerland – Austria (SR 0.672.916.31)
DTA CH-D	Double Taxation Convention Switzerland – Germany (SR 0.672.913.62)
DTA CH-F	Double Taxation Convention Switzerland – France (SR 0.672.934.91)
DTA CH-UK	Double Taxation Convention Switzerland – United Kingdom (SR 0.672.936.711)
DTA CH-USA	Double Taxation Convention Switzerland – United States of America (SR 0.672.933.61)

DTC	Double Taxation Convention
EBIT	Earnings before Interest and Taxes
EBITDA	Earnings before Interest, Taxes, Depreciation and Amortisation
ed.	editor(s) or edition
EF	Expert Focus (Review)
etc.	et cetera
EU	European Union
FC	Federal Constitution (*Bundesverfassung*, SR 101)
FCY	Foreign Currency
FDTA	Direct Tax Act (*Bundesgesetz über die direkte Bundessteuer*, SR 642.11)
FF	Federal Gazette (*feuille fédérale*)
fn.	footnote
FTHA	Federal Act on the Harmonisation of direct cantonal and communal Taxes (*Bundesgesetz über die Harmonisierung der direkten Steuern der Kantone und Gemeinden*, SR 642.14)
GAAR	General Anti-Avoidance Rule
Habil.	Habilitation thesis
i.c.	*in casu*
IFF	Institute of Public Finance, Fiscal Law and Law and Economics (University of St.Gallen)
IFRS	International Financial Reporting Standards
incl.	including
iStR	International Tax Law (Review) (*Internationales Steuerrecht*)
kCHF	thousand Swiss francs
LU	Canton of Lucerne
MNEs	multinational enterprises
MV	market value
N	marginal number
NF	Fiscal News (Review) (*Novità fiscali*)
OECD	Organisation for Economic Co-operation and Development
OECD-MC	OECD Model Convention with respect to taxes on income and capital
OSF	Ordinance on tax deduction for self-financing of legal entities (SR 642.142.2)
para.	paragraph
RDAF	Administrative and Tax Law Review (*Revue de droit administratif et de droit fiscal*)
SAAR	Specific Anti-Avoidance Rule

SDA	Stamp Duty Act (*Bundesgesetz über die Stempelabgaben*, SR 641.10)
SFTA	Swiss Federal Tax Administration (*Eidgenössische Steuerverwaltung*)
SGK	St.Gallen Commentary (*St.Galler Kommentar*)
SICAF	Investment company with fixed capital
SICAV	Investment company with variable capital
SJZ	Swiss Lawyers' Review (*Schweizerische Juristen-Zeitung*)
SR	Systematic Collection of Swiss Federal Law (*Systematische Sammlung des Bundesrechts*)
SRL	Systematic Collection of Laws of the Canton of Lucerne (*Systematische Rechtssammlung des Kantons Luzern*)
ST	The Swiss Fiduciary (Review) (*Der Schweizer Treuhänder*)
StR	Tax Review (*Steuer Revue*)
TA-LU	Tax Act of the Canton of Lucerne (*Steuergesetz des Kantons Luzern*, SRL 620)
TA-ZH	Tax Act of the Canton of Zurich (*Steuergesetz des Kantons Zürich*, ZH-Lex 631.1)
TO	Tax Ordinance (*Steuerverordnung*)
TREX	The Fiduciary Expert (Review) (*Der Treuhandexperte*)
UK	United Kingdom
VCLT	Vienna Convention on the Law of Treaties (SR 0.111)
vol.	volume
vs.	versus
WHTA	Withholding Tax Act (*Verrechnungssteuergesetz*, SR 642.21)
WHTO	Withholding Tax Ordinance (*Verrechnungssteuer-verordnung*, SR 642.211)
ZH	Canton of Zurich
ZH-Lex	Zurich Collection of Laws (*Zürcher Gesetzessammlung*)
ZSR	Swiss Law Review (*Zeitschrift für Schweizerisches Recht*)

Illustrations

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1 Introduction

1.1 Problem Definition

The preferred tax treatment of debt compared to equity financing[1], as well as the simplicity of adjusting the mix of debt and equity in a controlled entity, make debt financing worldwide one of the principal international tax planning strategies alongside transfer pricing and intangible assets.[2] Varying tax rates across jurisdictions further create tax arbitrage opportunities for multinational enterprises (MNEs), by way of which they can reduce their overall tax burden. Several academic studies have evidenced that MNEs use more debt than comparable widely held or domestically owned businesses.[3] Academics have also shown that MNEs place, by means of intragroup financing, higher levels of debt in subsidiaries located in high-tax countries, thus achieving lower net taxable profit through higher interest deduction.[4] MNEs make extensive use of these debt tax planning strategies to create value.[5] Intragroup debts also have the advantage not to affect the consolidated financial statements of MNEs as accounting standards do not recognise them.[6] Although these tax planning strategies are lawful, they undermine the fairness and integrity of tax systems because MNEs gain a competitive advantage over domestic entities.[7]

In order to limit borrowing and shifting interest income abroad, many countries have enacted thin capitalisation regulations, which restrict the tax deductibility of interest payments. At the international level, the OECD, in cooperation with the finance ministers of the G20 countries, took the issue as one of the 15 actions of the Base Erosion and Profit Shifting (BEPS) Action Plan.[8] Such Action Plan, which started in 2013, aims at developing minimal standards, recommendations and best practices to "restore the trust of ordinary people in the fairness of their tax systems, to level the playing field among businesses, and to provide governments with more efficient tools to ensure the effectiveness of their sovereign tax policies".[9] In October 2015, the OECD/G20 published its final reports on the BEPS Action Plan. The report on Action 4 analysed several best practices and recommended an approach which directly

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1 I.e. interests on loans are generally deductible and reduce the tax base of the borrower, while dividend distributions generally do not reduce the borrower's tax base.

2 KAHLENBERG/KOPEC, p. 84; BRÜGGER/RECHBERGER, p. 195; KAYIS-KUMAR, p. 363.

3 EGGER/EGGERT/KEUSCHNIGG/WINNER, p. 106; MINTZ/WEICHENRIEDER, p. 17. See also RUCHELMANN/SHAH, p. 17.

4 MØEN/SCHINDLER/SCHJELDERUP/TROPINA, p. 38; HUIZINGA/LAEVEN/NICODEME, p. 114.

5 GEHRIGER, p. 434; TELL, p. 750. Value creation is considered as the ultimate objective of any company following a shareholder value approach.

6 TING, p. 81.

7 TELL, p. 750.

8 Already in the 1970s and 1980s, the OECD addressed the global issue of undercapitalisation and profits shifting through interest payments. It dealt with this issue in general terms in 1979 and in greater depth in 1986 in a special report. See OECD, Thin Capitalization Report 1986, N 1 et seq.

9 OECD/G20, Explanatory Statement, N 3.

addresses the risks outlined above.[10] In December 2016, the OECD/G20 released an updated report.[11] Within the European Union (EU), a similar approach as suggested by the OECD/G20 has been introduced in article 4 of the Anti-Tax Avoidance Directive of 12 July, 2016 (ATAD). However, the OECD/G20 recommended approach, as well as the article 4 ATAD, leave member states with a certain degree of leeway in the design of the thin capitalisation rule, as several elements are optional.[12]

1.2 Object of Investigation and Purpose of this Thesis

As part of the Eucotax Wintercourse 2020, this thesis aims at describing whether, and if applicable, how the BEPS Action 4 and the ATAD have impacted Switzerland's domestic interest limitation rules. It also strives to analyse and evaluate how Swiss thin capitalisation rules should be designed from a tax policy perspective. This matter is significant for the small and open Swiss economy as foreign multinationals employ almost 470,000 persons in the country, accounting for about 10% of total employment.[13] Switzerland is generally considered as a low-tax country in the OECD. Nevertheless, Switzerland is actively participating in and contributing to the BEPS project. As a matter of principle, Switzerland agrees on the need to counter BEPS at a multilateral level.[14]

In the course of this thesis, the terms "thin capitalisation" and "interest limitation" rules are used as synonyms.[15] With regard to the BEPS project, this thesis only addresses Action 4 in detail. Other Actions of such project are, at most, marginally considered.[16] Further, this thesis does not discuss in detail the specific issues related to financial institutions. All sources of law have been taken into account as of 1 January, 2020.

1.3 Structure of this Thesis

This thesis is organised into six parts. First, chapter 2 provides an overview of the Swiss tax system, which will be useful for the rest of the thesis. Then, chapter 3 presents the treatment of debt and equity in domestic and international tax law. The Swiss interest limitation rules before (chapter 4) and after (chapter 5) BEPS Action 4 are subsequently analysed. Chapter 6 investigates the interaction of domestic interest limitation rules with other tax rules, especially provisions of double tax conventions. Finally, chapter 7 proposes four different fiscal policy options, one of which is the introduction of the OECD/G20 recommended approach.

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10 OECD/G20, BEPS Action 4 Final Report, p. 1 et seq.

11 OECD/G20, 2016 Update, N 1 et seq.

12 See OECD/G20, 2016 Update, N 23. See also section 5.1.

13 SWISS FEDERAL STATISTICAL OFFICE, multinationals, p. 1.

14 See DANON/SCHELLING, p. 197.

15 They refer to statutory provisions, which do not recognise interest payments to shareholders or third parties as operating expenses in whole or in part due to an excessively high allocation of borrowed capital.

16 One should note that Action 2 on hybrid instruments and entities, Action 3 on Controlled Foreign Company regimes and Action 9 on transfer pricing issues regarding risks and capital also address issues arising from intragroup debts.

2 Overview of the Swiss Tax System

In this chapter, an overview of the taxation authorities and legislative hierarchy (section 2.1) as well as of the general principles of taxation (section 2.2) in Switzerland will first be provided to give a basic understanding of the Swiss tax system. A focus will then be put on direct taxation (section 2.3) as it is the main topic of this thesis. Finally, the corporate tax reform III, which entered into force on 1 January, 2020 will briefly be presented (section 2.4).

2.1 Three Levels of Taxation Authorities and Legislative Hierarchy

As of 1 January, 2020, Switzerland, officially the Swiss Confederation, was a federal republic composed of one federation, 26 cantons and 2202 communes (municipalities).[17] Each layer (federal, cantonal and communal) has administrative and legislative power.[18] The *Constitution* is the hierarchically highest code at the federal and cantonal level. Amendments of such code generally need the approval of the people of Switzerland, respectively of the people of the relevant canton for the cantonal Constitution.[19] The second level in the legislative hierarchy is the *law*, which is enacted by the (federal, respectively cantonal) parliament.[20] The (federal, respectively cantonal) executive power can finally enact *ordinances*, which are the third and lowest level in the legislative hierarchy.[21]

According to article 3 of the Federal Constitution (FC), which is, therefore, the highest code of the whole Swiss Confederation, the cantons are sovereign except to the extent that the FC limits their sovereignty. This principle implies that the cantons are competent concerning both tax legislation and enforcement unless the FC expressly reserves a competence for the federation (federal level).[22] Further, the communes may levy taxes only to the extent that the cantonal legislation explicitly authorises them.[23] Where no special regulations exist, cantonal and communal taxes are established in accordance with cantonal law.[24] Thus, the communal taxing powers are subject to the same federal law limitations as the cantonal taxing powers.

Federal limitations to the cantonal fiscal sovereignty include the exclusive competence conferred by the FC upon the federation to levy a value-added tax (VAT), various special consumption taxes, a stamp duty and a withholding tax.[25] The FC also provides the federation with the obligation to harmonise the direct taxes imposed at the federal, cantonal and

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17 SWISS FEDERAL STATISTICAL OFFICE, Gemeinden, p. 1.

18 Art. 42 et seq. FC.

19 See art. 194 FC and e.g. art. 132(3) C-ZH.

20 Art. 163(1) FC and e.g. art. 50(1) C-ZH.

21 Art. 182(1) FC and e.g. art. 67(2) C-ZH. The executive power nonetheless needs to be authorised to enact such ordinances by the Constitution or the law.

22 OBRIST, p. 47.

23 FEDERAL TAX ADMINISTRATION, p. 9; BGE 126 I 122, cons. 2b.

24 See art. 51 FC regarding the adoption of a cantonal Constitution.

25 Art. 134 FC.

communal level.[26] Based on that competence, the federal legislator enacted the Tax Harmonisation Act (FTHA) that contains a catalogue of the taxes the cantons must levy and lays down the principles according to which the cantonal legislation must establish them.[27] Another limitation to the cantonal fiscal sovereignty is article 54(1) FC that assigns the responsibility for foreign relations, including international tax matters, to the federation and not to the cantons.

2.2 General Principles of Taxation

As every governmental body, all three levels of taxation authorities have to comply with the principles of the FC. Concerning taxation, article 127(1) FC requires the main structural features of any tax, in particular, the status of the taxpayer, the object of the tax and its method of calculation to be defined in the law and not in an ordinance (so-called *principle of legality*).[28] Further, the following three principles apply to every tax, provided its nature permits it[29]:

1. The *principle of universality of taxation*, which requires all persons or groups of persons to be taxed according to the same legal rules and prohibits exceptions without an objective reason.
2. The *principle of uniformity of taxation*, according to which persons in equal circumstances are to be taxed in the same way and substantial disparities in circumstances must correspondingly lead to differentiated taxations.
3. The *ability-to-pay principle*[30], which requires every taxpayer to contribute to the financial needs of the community in proportion to the resources available to him (vertical tax justice). Further, persons or groups of persons with the same income should pay the same amount of tax (horizontal tax justice).

2.3 Direct Taxation

2.3.1 Preliminary Notes

This thesis relates primarily to direct, rather than indirect taxation. Thus, the indirect taxes levied in Switzerland (such as VAT, stamp duty, gift and inheritance taxes) will not be further

[26] Art. 129(1) FC. The harmonisation extends to the tax liability, the object of the tax, the tax period, the procedural law and the law relating to tax offences. The harmonisation explicitly excludes the tax scales, the tax rates and the tax allowances, see art. 129 (2) FC.

[27] Art. 1(1) FTHA. According to art. 2(1) FTHA, the cantons shall levy, among others, an income tax and a wealth tax for individuals as well as an income tax and a capital tax for legal entities.

[28] See also art. 5(1) and 164(1)(d) FC.

[29] Art. 127(2) FC. These principles are derived from art. 8(1) FC (general principle of equality) and art. 9 FC (prohibition of arbitrary action), see BGE 133 I 206, cons. 6.1; BGE 128 I 240, cons. 2.3; BGE 114 Ia 221, cons. 2c.

[30] BGE 133 I 206, cons. 7; REICH, Leistungsfähigkeitsprinzip, p. 16 et seq. The ability-to-pay principle also applies to legal entities, see BÖHI, verdecktes Eigenkapital, p. 54 et seq.; SGK BV-VALLENDER/WIEDERKEHR, art. 127 N 24.

discussed.[31] Concerning direct taxation, the FC allows the federation to levy an individual and a corporate income tax but only until a certain expiration date, i.e. the federation needs the regular approval of the people of Switzerland to keep the power to levy such taxes.[32] The Federal Direct Tax Act (FDTA) regulates in detail the federal direct taxation. At the cantonal level, each of the 26 cantons has its own tax law. Nevertheless, as stated above, all cantonal tax laws are based upon the FTHA.[33] Although the FTHA has significantly improved tax harmonisation in Switzerland, the cantons and the communes still have a significant degree of independence, especially concerning the rates of taxation.[34] This thesis will thereafter only refer to the FTHA and not to the 26 cantonal tax laws.

This introduction to direct taxation in Switzerland will now briefly present the conditions of the tax affiliation in Switzerland (section 2.3.2), the Swiss corporate income (section 2.3.3) and capital (section 2.3.4) taxes as well as the withholding tax (section 2.3.5). The individual income and wealth taxes will not be further examined, as they are mostly irrelevant to this thesis.

2.3.2 Conditions of Tax Affiliation

Legal entities[35] are considered residents and thus subject to full taxation if (i) their place of incorporation (i.e. according to the statutory seat) or (ii) their place of effective management is located in Switzerland.[36] The place of effective management corresponds to the place where the senior management takes the essential decisions regarding the day-to-day business (and not the strategic decisions) of the company.[37] Legal entities which have neither their registered office nor their place of effective management in Switzerland are nonetheless subject to (limited) taxation based on *economic affiliation* if (i) they are associated with a company established in Switzerland, (ii) they have permanent establishments in Switzerland or (iii) they own or broker real estate in Switzerland.[38] Foreign legal entities, as well as foreign entities and partnerships taxable based on economic affiliation, shall be treated as equivalent to the domestic legal form that they legally or factually most closely resemble.[39]

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31 For an introduction about these taxes in English, see OBERSON/HULL, p. 17 et seq.

32 See art. 128(1) and 196(13) FC. The power to levy the direct federal tax is currently limited until the end of 2020. The reason for this restriction relies on the fact that the federation must leave the cantons with sufficient financial resources to fulfil their tasks (art. 47(2) FC).

33 For example, compare the FTHA and the TA-ZH.

34 OBERSON/HULL, p. 3. There are significant differences between cantons and communes.

35 Simple, general and limited partnerships (see art. 530 et seq., 552 et seq. and 594 et seq. CO) do not qualify as legal entities. Their income is attributed proportionately to the income of the holders and therefore subject to individual income tax (art. 10(1) FDTA).

36 Art. 50 FDTA and 20(1) FTHA. This principle applies to federal, cantonal and communal tax affiliation. See BSK FDTA-OESTERHELT/SCHREIBER, art. 50 N 2 et seq.

37 HÖHN/WALDBURGER, Band I, §17 N 12; REICH, § 19 N 5a.

38 Art. 51 FDTA and 21 FTHA.

39 Art. 49(3) FDTA and 20(2) FTHA.

2.3.3 Corporate Income Tax

Federal and cantonal corporate income taxes are levied on the worldwide net income of Swiss resident joint-stock companies (stock corporations, partnerships limited by shares, limited liability companies) as well as cooperatives, associations and foundations, except for income attributable to foreign enterprises, permanent establishments or real estate.[40] In the case of economic affiliation (see section 2.3.2), the tax duty is limited to the taxable profits from Swiss enterprises, permanent establishments or real estate.[41] Taxpayers who have their registered office and place of effective management abroad are only liable for income tax on their profits made in Switzerland.[42] From a theoretical point of view, the *total profit principle* states that a company should not pay tax on more than its actual profits during its entire lifetime. The taxable profit of the corporation is determined based on the *periodicity principle* in specific periods. As part of the one-year assessment, these periods are based on the company's financial periods, which also serve as tax periods.[43]

The object of the corporate income tax is the net income.[44] The net taxable income is composed of the gross income (including all extraordinary income such as capital gains, liquidation gains and revaluation gains) generated during the financial period reduced by all justifiable expenses. These are all expenses that are economically justifiable for the correct undertaking of the business, such as wages, rent, marketing and working stock.[45] The difference between the equity capital at the beginning and the end of the financial year, less any capital contributions plus all capital withdrawals must finally be taxed.[46] The tax authorities use the balance of the income statement following commercial law as a basis for calculating the net taxable income (so-called *principle of determinance*).[47] However, tax law stipulates some correction provisions that limit commercial law.[48] Indeed, all expenses not commercially justified by business reasons and all income not credited to the income statement must be added to net income.[49] A net loss may be carried forward for the next seven years.[50]

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40 Art. 49(1), 49(2), 50 and 52(1) FDTA; art. 20 FTHA.

41 Art. 51 and 52(2) FDTA; art. 21 FTHA.

42 Art. 52(4) FDTA.

43 See art. 79 FDTA and 31 FTHA; BLUMENSTEIN/LOCHER, p. 231; SIMONEK, p. 514.

44 Art. 57 FDTA; art. 24 FTHA.

45 OBERSON/HULL, p. 10. All commercially justified expenses may be deducted. Even federal, cantonal and municipal taxes are deductible. See art. 59(1)(a) FDTA and art. 25(1)(a) FTHA.

46 BGer 20 October, 2014 (2C_634/2012), cons. 5.2.1; BGE 98 Ib 404, cons. 1; BÖHI, verdecktes Eigenkapital, p. 69; SIMONEK, p. 515.

47 NOBEL, p. 877; HÖHN/WALDBURGER, Band II, § 46 N 11.

48 REICH, §20 N 1 et seq. The reason is that commercial and tax law pursue different objectives. Commercial law is characterised by creditor protection and the precaution principle. In contrast, tax law aims to determine the actual taxable profit for the period, which corresponds to the actual economic performance of the taxpayer.

49 Art. 58(1)(b) FDTA; art. 24(1)(a) FTHA. For example, not commercially justified depreciations and provisions must be added back to the net income. See also art. 59 FDTA et 25 FTHA.

At the federal level, the corporate income tax rate for corporations and cooperatives is 8.5% of net income (art. 68 FDTA). For associations and foundations, a flat rate of 4.25% on net taxable income over CHF 5,000 applies (art. 71 FDTA). Cantonal and communal tax rates vary depending on the canton and commune involved. For example, the cantonal tax rate in the canton of Zurich amounts to 8%.[51] When the profit is subject to income tax at the level of the legal entity and the distributed profit is subject to income tax (individuals) or profit tax (legal entities) at the level of the shareholder, this results in *double economic taxation*.[52] A participation relief procedure exists to mitigate this economic double taxation for legal entities. Such participation relief corrects the multiple taxations that can result from profit distributions over several levels of legal entities. The profit tax of a corporation is reduced according to the ratio of net income from participations to the total net income if the corporation (i) holds at least 10 % of the equity of another company, (ii) holds the rights to at least 10% of the profits and reserves of another company or (iii) holds participations with a market value of at least CHF 1 million.[53]

2.3.4 Corporate Capital Tax

Unlike the income tax, the federation is not allowed to impose a capital tax on Swiss resident corporations. However, the cantons, and in some cases also the communes, levy such capital tax on the equity of corporations.[54] As the corporate income tax, the taxable equity is determined based on the balance sheet established under commercial law.[55] It generally includes the paid-in share capital, the open reserves and the hidden reserves formed with taxed profits.[56] The capital tax rate varies depending on the canton and the commune. On average, it is approximately between 0.01% and 0.5%.[57] When the capital is subject to capital tax at the level of the corporation and the participation rights of the shareholder are subject to wealth tax (individuals) or capital tax (legal entities), there is also a double economic taxation.[58] To alleviate the economic double taxation on capital, various cantons have introduced a participation deduction on capital for companies subject to ordinary taxation.[59] However, at the level of

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50 Art. 67 FDTA; art. 25(2) FTHA. Unlike many foreign tax systems, the direct federal tax does not distinguish between different categories of business losses. Further, Swiss law does not permit the deduction of future losses, see OBERSON/HULL, p. 13; SIMONEK, p. 516.

51 Art. 71 TA-ZH.

52 HÖHN/WALDBURGER, Band II, § 45 N 20; REICH, § 18 N 35.

53 Art. 69 et seq. FDTA and art. 28(1) to 28(1ter) FTHA. Net income from participations corresponds to the earnings on these participations less the financing costs related thereto, plus 5% to cover administrative expenses. Financing costs consist of interest on the debt and other costs which are economically equivalent thereto. Earnings from participations also include the capital gains on such participations as well as the proceeds from related subscription rights.

54 Art. 2(1)(b) and 29 FTHA. See NOBEL, p. 877.

55 Art. 31(4) FTHA; see e.g. art. 79(1) TA-ZH.

56 Art. 29(2)(a) FTHA.

57 EY, p. 1; OBERSON/HULL, p. 14. Capital tax rates have been reduced as part of the Corporate Tax Reform III. E.g., in the canton of Zurich, the tax rate amounts to 0.075% and the equity capital below CHF 100,000 is not taxed, see art. 82 TA-ZH.

58 REICH, wirtschaftliche Doppelbelastung, p. 25 et seq. and 60 et seq.; OBERSON, p. 258 et seq.

59 See e.g. art. 90(2) TA-LU.

individuals residing in Switzerland, no provision reduces the double economic taxation on capital.[60]

2.3.5 Withholding Tax

Based on article 132(2) FC, the federation levies a 35% withholding tax on certain types of income from movable capital assets and lottery winnings from Swiss sources.[61] The Federal Withholding Tax Act (WHTA) and Ordinance (WHTO) govern the withholding tax. As "income from movable capital assets" qualify all interests, rents, profit shares and other income from (i) bonds, mortgages and annuity letters issued in series by a person domiciled in Switzerland and (ii) shares, interest in limited liability companies, cooperative companies, participation certificates and profit-sharing certificates issued by a person domiciled in Switzerland.[62] Balances between group companies are not treated as bonds irrespective of their maturity, currency or interest rate.[63] Also subject to withholding tax are undeclared profit distributions, liquidation surpluses, payments in kind without withdrawal of capital (e.g. free nominal value increase or free shares) and, under certain circumstances, the repurchase of company shares.[64] The withholding tax is levied at source, i.e. on the debtor and not on the recipient of the income. At the payment, transfer, crediting or billing, the debtor must deduct the amount of withholding tax, without regard to the recipient, and must pay that amount directly to the Swiss Federal Tax Administration (SFTA).[65] The withholding tax is therefore passed on to the recipient of the benefit, who is ultimately the tax carrier. Recipients of taxable benefits with full or limited tax liability in Switzerland are entitled to reimbursement of the deducted withholding tax, given they are the beneficial owner of the taxable benefits and declare the according income and assets for income and capital tax purposes.[66] For them, the withholding tax is an incentive to declare their taxable income regularly.[67] Individuals and entities without tax liability in Switzerland can only apply for (partial or full) reimbursement based on international tax treaties.[68]

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60 BÖHI, verdecktes Eigenkapital, p. 61 et seq.

61 Art. 4 to 8 and 13(1)(a) WHTA. Cantons and communes are not authorised to levy a similar withholding tax (art. 134 FC).

62 Art. 4(1)(a) and (b) WHTA as well as art. 14 et seq. WHTO. See also art. 4(1)(c) and (d) WHTA.

63 Art. 14*a*(1) WHTO. This rule does not apply if a domestic group company guarantees a foreign group company bond and the funds transferred from the foreign group company to the domestic group company exceed the amount of equity of the foreign group company as of the balance sheet date, see art. 14*a*(3) WHTO. See also: HUBER/MAHAWATTAGE/ZAHND/BUCHER/BULARD, p. 259.

64 HÖHN/WALDBURGER, Band I, § 21 N 13 et seq.; NOBEL, p. 881 et seq. Regarding the repurchase of shares, see art. 4*a* WHTA; BGE 136 II 33, cons. 2; BGer 9 June, 2015 (2C_928/2014), cons. 4.

65 See art. 14(1) WHTA. Any agreement to the contrary is nil and void. Whoever omits the shifting of withholding tax is subject to a fine of up to CHF 10,000 (art. 63 WHTA).

66 Art. 1(2) and 21 to 28 WHTA. Regarding the term "beneficial owner", see BGE 141 II 447, cons. 4.2 et seq. Regarding the conditions of the reimbursement, see MÄUSLI-ALLENSPACH/OERTLI, p. 374.

67 BGE 125 II 348, cons. 4; BGer 7 March, 2014 (2C_732/2013), cons. 2.1; REICH, § 28 N 6 et seq.; OBERSON/HULL, p. 16; DURANT, p. 35.

68 In case no international tax treaty exists, the Swiss withholding tax represents a final tax on investment income from Swiss source. See REICH, § 28 N 8. For all EU member states, the withholding tax is fully discharged in group relationships based on art. 9 AEOI CH-EU.

For withholding taxes that arise within a group of companies, the law provides for a procedural simplification to fulfil the tax obligation. A corporation holding at least 20% of the share capital of a subsidiary can instruct it to use an official form to proceed with the payment without deduction of withholding tax.[69] The subsidiary must complete the form and submit it to the SFTA.[70] An analogous reporting procedure also exists for dividends paid to a related foreign company if there is a double taxation agreement between the foreign country and Switzerland.[71]

2.4 Corporate Tax Reform III

The Corporate Tax Reform III was launched in 2008 and was triggered, among others, by international pressure – mainly stemming from the EU – to abolish cantonal preferential tax regimes for holding, domicile and mixed companies.[72] The special feature of these tax regimes was that the mentioned companies did not have to pay any or a reduced income tax, and in most cases a reduced capital tax, at cantonal and municipal levels, despite unlimited tax liability in Switzerland.[73] According to the EU, such tax regimes were infringing the Free Trade Agreement between Switzerland and the EU by advantaging certain competitors and thus distorting cross-border trade.[74] After a first rejection on 12 February, 2017, the people of Switzerland accepted the Corporate Tax Reform III proposed by the government on 19 May, 2019.[75] The reform entered into force on 1 January, 2020.[76] Even if the Corporate Tax Reform III was not a direct consequence of the BEPS project, it has been highly influenced by the work of the OECD/G20 as one of the three goals of the reform was to restore the international acceptance of the Swiss corporate tax system.[77]

Except for the said abolition of harmful tax privileges, the approved tax legislation, *inter alia*, introduced a patent box, adjusted the dividend taxation for individuals, the capital contribution principle and the lump-sum tax credit system as well as provided for immigration step-up.[78] It

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69 Art. 20 WHTA and art. 26*a*(1) WHTO.

70 Art. 26*a*(2) WHTO.

71 See the Ordinance on the Tax Relief of Swiss Dividends from Substantial Participations of Foreign Companies (SR 672.203).

72 HONGLER, BEPS, p. 103; SIMONEK/HONGLER, p. 572. See art. 28(2), 28(3) and 28(4) aFTHA. The holding privilege could only be used by companies whose participations accounted for at least two-thirds of the total assets (or if the returns accounted for at least two-thirds of the earnings).

73 See HÖHN/WALDBURGER, Band I, § 20 N 1 et seq.; NOBEL, p. 874 et seq.

74 For more details about the conflict between the EU and Switzerland and the genesis of the reform, see MATTEOTTI/ROTH, p. 681 et seq.

75 The reform was linked to the financing of the old-age and survivor's social insurance (AHV). Switzerland was finally removed from the EU's grey list of tax havens on 10 October, 2019.

76 There is no transitional period for the cantons. However, most of them have already taken steps to adapt their tax regimes.

77 HONGLER, BEPS, p. 103. For more details, see Message Corporate Tax Reform III, p. 4636.

78 See art. 24*a*-24*b* FTHA, art. 18*b*(1), 20(1bis) and 20(3) to (7) FDTA as well as art. 7(1) and 8(2^{quinquies}) FTHA, art. 7*b* FTHA, art. 5(1ter) WHTA and art. 24(3bis) FTHA. Compensating for the additional profits arising out of the abolishment of cantonal tax privileges, most cantons plan to significantly reduce their corporate income tax rates down to an average effective tax rate of 12-16% (incl. direct federal tax).

also gave the cantons the possibility to grant a R&D super deduction, exemptions for capital tax purposes and a notional interest deduction on surplus equity.[79] Such surplus equity is the portion of equity exceeding the minimum equity required for long-term business activity (so-called core equity).[80] An Ordinance on tax deduction for self-financing of legal entities (OSF) specifies how this surplus equity is to be calculated (with minimum equity ratios) and defines the notional interest rate to be accepted, based on the rate paid on 10-year Swiss federal bonds.[81] However, if the surplus equity is attributable to related parties, e.g. group companies, it is possible to apply a higher (arm's length) interest rate.[82] Only cantons that provide for total effective income taxation of at least 18.03 % in the canton's capital city, i.e. only the canton of Zurich, may introduce it at present.[83]

3 Debt and Equity in Domestic and International Tax Law

This chapter defines and outlines the functions of equity, debt and hybrid financing (section 3.1). The treatment of the first two types of financing will then be examined under domestic (section 3.2) and international tax law (section 3.3).

3.1 Definition and Functions of Different Forms of Financing

3.1.1 Equity Financing

According to BOEMLE/STOLZ, equity corresponds to the capital made available by the company or its shareholders in the form of cash, other assets or by waiving the distribution of profits.[84] From an economic point of view, no clear line can be drawn between equity and debt financing.[85] For the delimitation between these two forms of financing, there is not one determinant factor. Rather, one needs to compare the individual financing with the basic functions of equity and debt.[86] Equity financing generally fulfils the following functions[87]:

- *Continuity and existence function*: The shareholders transfer equity to a company for unlimited time and without the possibility of termination, thus providing the company

[79] See art. 25, 29(3) and 25*a*^{bis} FTHA. BÖHI/HONGLER, p. 678. The idea of privileged taxation of interest income between group companies (group interest box) has also been discussed as part of the reform but was finally dropped out. See MATTEOTTI/ROTH, p. 681 et seq.

[80] For a calculation example, see STAUBLI/KÜTTEL, p. 572 et seq.; STAUBLI/KÜTTEL/RÖLLIN, p. 729 et seq.; GEHRIGER /SCHENK, p. 772.

[81] See Ordinance on tax deduction for self-financing of legal entities (OSF, SR 642.142.2).

[82] See art. 4 OSF regarding the determination of the part of equity attributable to related parties.

[83] Art. 25*a*^{bis}(1) FTHA; Commentary OSF, p. 8; HUBER/MAHAWATTAGE/BERR/BUCHER/BULARD, p. 446. The canton of Zurich introduced it on 1 January, 2020, see art. 65b et seq. TA-ZH.

[84] BOEMLE/STOLZ, p. 9 et seq. See also BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 9; LOCHER, art. 65 N 10 FDTA; VON SALIS-LÜTOLF, p. 179. From a balance sheet perspective, equity corresponds to the difference between the value of the company's assets and liabilities. It is, therefore, a residual amount.

[85] HONGLER/BÖHI, p. 131; MASSBAUM, p. 8.

[86] BÖHI, verdecktes Eigenkapital, p. 157 et seq.; HONGLER/BÖHI, p. 131.

[87] See BÖHI, verdecktes Eigenkapital, p. 9 et seq. and p. 157 et seq. for more details.

with capital to achieve its business activities permanently.[88]

- *Loss compensation function*: Equity serves as a (first) cushion for entrepreneurial risks as the net loss is subtracted from shareholders' equity. In the event of liquidation, shareholders are served only after all other debtors.[89]
- *Liability function*: The shareholders have unlimited liability but only up to the amount of their investment. The equity on the balance sheet, therefore, represents the maximum liability of the legal entity.[90]
- *Profit participation function*: The shareholders receive a proportionate part of the profits based on their shareholdings.[91]
- *Control function*: Shareholders usually have voting rights that they can exercise at the annual general meeting.[92]

As outlined above (sections 2.3.3 and 2.3.4), the tax authorities in Switzerland rely primarily on commercial (civil) law to determine the taxable net profit and capital.[93] The definition of equity for tax purposes is, therefore, generally based on commercial law in Switzerland.[94] According to commercial law, the following qualify as equity: (i) the share capital, including any premiums paid above the nominal value[95], (ii) the statutory capital reserves, (iii) the statutory retained earnings, (iv) the voluntary retained earnings (or accumulated losses as negative items) and (v) the own capital shares as negative items.[96]

3.1.2 Debt Financing

Debt financing is generally defined as capital made available to a company by third parties for a specified period.[97] The lender receives periodic interest payments from the debtor and recovers his[98] invested capital at the end of the term, irrespective of the company development.[99] In comparison to a shareholder, the lender has less risk of loss due to priority

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88 See art. 680(2) CO.

89 Therefore the amount of equity usually influences the creditworthiness of the company.

90 For this reason, the equity is generally visible for the creditors (and anyone else) in the relevant commercial register.

91 According to art. 675(1) CO, no interest can be paid on the share capital. See art. 660(1) CO regarding dividend payment.

92 See art. 698 CO.

93 Nevertheless, a reclassification of financing based on tax law norms may occur.

94 See PILTZ, p. 48.

95 Art. 624(1) CO; BÖCKLI, § 8 N 294 et seq.

96 Art. 959*a*(2) and 959*a*(3) CO.

97 BOEMLE/STOLZ, p. 14.

98 The person-related expressions included in this thesis (using as a default the male form) are to be understood gender-neutral.

99 PILTZ, p. 25. See also art. 312 CO. The interest rate is generally determined, *inter alia,* by the borrower's credit risk, the guarantees provided by the borrower as well as the duration and the currency of the loan. See DEJARDIN, p. 142.

satisfaction in case of liquidation but does not participate in the company profit.[100] Neither has he voting rights or other means to participate in the company.[101] From a balance sheet point of view, debt financing is part of the liabilities of the company, along with the operating liabilities (such as supplier debts and provisions).[102]

Swiss commercial law does not provide any differentiation criteria between equity and debt financing. However, the differentiation is of central importance, as there is no intermediate form of financing from a legal point of view.[103] To distinguish equity from debt financing, one should rely upon the structure chosen by the parties and their subjective will, irrespective of the economic functions of the financing.[104] The principle *form over substance* thus applies in Swiss commercial law.[105] This implies that debt financing always exists when the reason for the capital contribution lies in a loan or another *contractual* relationship and the lender does not acquire the capacity of shareholder according to corporate law.[106] Swiss commercial law does not contain any provisions regarding the debt to equity ratio but charges the board of directors with the non-transferable and inalienable duty to ensure that the company is adequately capitalised.[107]

3.1.3 Hybrid Financing

Unlike the legal perspective, the limits between debt and equity financing are blurred from an economic point of view.[108] Both ideal types of equity and debt financing can be combined in various ways as hybrid forms. Hybrid financing is thus a form of financing that has both debt and equity characteristics.[109] Classic examples of such financial instruments are preferred shares, convertible bonds or shareholder loans, which generally satisfy some (economic) functions of both equity and debt financing. A precise definition of hybrid financing is difficult due to the variety of this type of financing. Basically, hybrid financing is subordinated to typical debt capital but has precedence over equity capital in case of liquidation. It is generally entitled to interest payments and has some equity characteristics, e.g. profit participation or a convertible right (in equity).[110] As previously stated, the tax qualification as equity or debt

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[100] BOEMLE/STOLZ, p. 14.

[101] BÖHI, verdecktes Eigenkapital, p. 38.

[102] According to commercial law, liabilities must result from past events, which generate a probable outflow of economic benefits to the company and whose value can be estimated with a sufficient degree of reliability. See art. 959(5) CO. Regarding the minimal structure of liabilities that are to be presented in the balance sheet, see art. 959*a*(2)(1) and 959*a*(2)(2) CO.

[103] BGE 121 III 319, cons. 5cc.

[104] BÖCKLI, § 8 N 297.

[105] BÖHI, verdecktes Eigenkapital, p. 39; HOHMANN/MÜLLER, p. 687.

[106] MEISTER, p. 114, according to which a debt must be assumed as long as the contractual relationship does not qualify as participation right. See also HINNY, p. 34.

[107] Art. 716*a*(1)(3) in conjunction with art. 725(2) CO; CR LIFD-DANON, art. 65 N 4 FDTA. See also GLANZMANN, p. 58.

[108] See sections 3.1.1 and 3.1.2.

[109] DUNCAN, p. 53.

[110] BÖHI, verdecktes Eigenkapital, p. 16.

relies *prima facie* on the commercial law, which does not know anything between equity and debt.[111] From a legal (tax) perspective, hybrid financing will, therefore, be considered as equity only if a corporate law decision creates a participation right (*Beteiligungspapier*). In contrast, the hybrid financing based on contract law will be deemed as debt financing.

3.2 Treatment in Domestic Tax Law

3.2.1 Equity Financing

The issuance of equity by a domestic corporation is generally subject to a one-time stamp duty amounting to 1%.[112] Once equity is issued, the corporation must pay the cantonal (and sometimes municipal) capital tax as per the principles outlined in section 2.3.4.[113] Profit distributions to shareholders, like dividends, are part of the taxable profit and are therefore not deductible as business expenses by the corporation.[114] Further, such profit distributions are generally subject to the withholding tax of 35% that is to be borne by the shareholder.[115]

Assuming the shareholder is an individual and equity is held for private purposes only, profit distributions are taxed as income from movable assets and capital gains arising from the sale of equity are tax-free.[116] The shares must be declared and are subject to cantonal and communal wealth tax.[117] In case equity is held by a legal entity or by an individual, but for business purposes, both profit distributions and capital gains from the sale of equity are taxed as income.[118] Equity financing is therefore subject to economic double taxation through corporate and individual income taxes as well as through individual wealth und corporate capital taxes.

3.2.2 Debt Financing

Unlike equity, debt issuance is generally not subject to stamp duty, as it does not imply any change in the nominal value of the corporation's participation rights.[119] If the debt is issued from the private assets of an individual, the interests received by the lender are taxed as income from movable assets and capital gains on the transfer of debt are exempt from tax.[120]

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[111] See section 3.1.2.

[112] Art. 5 SDA. However, an exemption threshold of CHF 1 million applies, see art. 6(1)(h) SDA. Other taxation exceptions are described in art. 6 and 12 SDA.

[113] Art. 2(1)(b) and 29 FTHA; NOBEL, p. 877; SFTA-Circular 6, p. 1. For considerations about notional interest deduction (on surplus equity), see section 2.4 and OESTERHELT/SCHENK, p. 68 et seq.

[114] Art. 58(1)(b) FDTA and 24(1) FTHA. Regarding deemed (hidden) profit distribution, see section 4.6.

[115] Art. 4(1)(b) WHTA. See section 2.3.5.

[116] Art. 16(3) and 20(1)(c) FDTA; art. 7(1) and 7(4)(b) FTHA. Pursuant to art. 20(1bis) FDTA, dividends from shares in limited liability companies are only taxable to the extent of 60% if these participation rights represent at least 10% of the total share capital of a corporation. Regarding the taxation of professional securities dealers, see SFTA-Circular 36, p. 1 et seq.

[117] Art. 13(1) FTHA.

[118] Art. 18(1) and 18(2), 57 FDTA; art. 8($2^{quinquies}$) and 24(1) FTHA. However, participation relief exists for individuals according to art. 18b(1) FDTA and for legal entities according to art. 69 et seq. FDTA.

[119] Art. 5 SDA *a contrario*. See also BSK SDA-TADDEI/FELBER, art. 5, N 21.

[120] Art. 20(1)(a) FDTA and 7(1) FHTA; art. 16(3) FDTA and 7(4)(b) FHTA.

On the other hand, both the interests received and the capital gains from the transfer of debt are subject to income tax when debt is issued from business assets or when the lender is a legal entity.[121] Further, no withholding tax is levied on the simple payment of interest arising from a loan agreement between legal entities and/or individuals, in particular between companies in the same group.[122] There are two main exceptions to this general rule: (i) the interests on client assets with Swiss banks and (ii) the interests on bonds for which the debtor is domiciled in Switzerland.[123] In this context, according to the practice of the SFTA, a loan qualifies as a bond if its amount exceeds CHF 500,000 and (i) more than ten non-bank lenders invest at identical terms (*Anleihensobligationen*) or (ii) more than 20 non-bank lenders invest at different terms (*Kassenobligationen*).[124]

At the level of the borrower, neither capital nor wealth tax is levied on debt. If the borrower is either a corporate entity or if the loan relates to the business of an individual, interest expenses are deductible from taxable net income.[125] There is no detailed definition of the term *interest* for Swiss income tax purposes, but the distinction between interest and dividend payments is rather straightforward.[126] In principle, interests are all payments (excluding repayment) made on debt, as defined in section 3.1.2 above, be it on profit-participating loans, subordinated loans or (mandatory or contingent) convertible loans or bonds.[127] The deductibility of interests follows, therefore, a *form over substance* approach and also applies to financing forms economically close to equity.[128] In contrast, payments on equity instruments that are economically equivalent to interest will be considered as (non-deductible) profit distribution. Because the calculation of the income tax relies on commercial law (principle of determinance)[129], the interests have to be reflected as business expenses in the profit and loss statement to be deductible.[130] The tax deduction is unrelated to the (ordinary or specific) tax regime of the borrower, the jurisdiction of the lender and whether the interest received by

[121] Art. 18(1) and 18(2) FDTA as well as 8(1) FHTA; art. 57 FDTA and 24(1) FHTA.

[122] DURANT, p. 35.

[123] Art. 4(1)(a) and 4(1)(d) WHTA.

[124] SFTA-Circular 47, p. 2 et seq. See also art. 15 WHTO and SFTA-Circular 15, p. 3. Regarding the taxation of obligations, see HOHMANN/MÜLLER, p. 637 et seq.

[125] Art. 27(1), 27(2)(d) FDTA and 10(1)(e) FHTA; art. 58(1)(b) FDTA and 24(1) FHTA. If an individual takes a loan as part of his private wealth, i.e. not related to his business activities, interest deductions are limited to the income from movable and immovable assets plus CHF 50,000 (art. 33(1)(a) FDTA and art. 9(2)(a) FHTA), see BÖHI/HONGLER, p. 675.

[126] BÖHI/HONGLER, p. 676; UNTERSANDER, p. 716. For a definition of the term *interest* in civil law, see BGer 13 April, 2015 (2C_142/2014), cons. 2.2.4.

[127] The bifurcation approach, which splits income into an interest and a capital gain component, has also been applied to a few cases of financing such as traded mandatory or contingent convertible bonds, see BÖHI/HONGLER, p. 676 et seq. Regarding the taxation of hybrid financing instruments, see HONGLER, Finanzierungsinstrumente, p. 290 et seq. and HOHMANN/MÜLLER, p. 629 et seq.

[128] BÖHI/HONGLER, p. 677; HONGLER, Finanzierungsinstrumente, p. 51.

[129] Art. 58(1)(a) FDTA.

[130] BÖHI/HONGLER, p. 676. A mere deduction for tax purposes is not possible.

the latter is taxed.[131] The only limitation on deductible interests in Swiss tax law is a quantitative one: the tax administrations accept deductible interests as long as they do not consider them excessive.[132]

3.3 Treatment in International Tax Law

Most of the Double Taxation Agreements (DTA) Switzerland has concluded in the past correspond to the OECD Model Convention (OECD-MC).[133] Therefore, this chapter will mainly rely on the OECD-MC to analyse the treatment of equity and debt financing.

3.3.1 Equity Financing

Article 10(1) OECD-MC states that dividends paid by a company, which is a resident of a contracting state, to a resident of the other contracting state may be taxed in that other state. Besides, it provides for a taxation right of the source state.[134] The source state can apply its laws and levy the tax either as a withholding tax or by an individual assessment.[135] However, this taxation right is regularly capped if the beneficial owner of the dividends is a resident of the other contracting state. For example, if the beneficial owner is a company which holds directly at least 25 % of the capital of the company paying the dividends, the source state's right of taxation is limited to 5% of the gross amount of the dividends[136] or in some cases even completely excluded.[137] The levying of the withholding tax is independent of the income qualification in the country of residence.[138] In case of double taxation, the article 23A(2) OECD-MC prescribes the application of the exemption method.

The OECD-MC defines *dividends* as income from shares, *jouissance* shares or *jouissance* rights, mining shares, founders shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.[139] According to the commentary of the OECD-MC, article 10 also

[131] BÖHI/HONGLER, p. 676. There are no linking rules in place applying at the level of the borrower. Switzerland has not intended to implement such linking rules.

[132] See section 4.3. All expenses, which are not commercially justified, will be added back to the taxable net income.

[133] The federation, and not the cantons, has the competence to conclude DTAs (art. 54(1) FC). The DTAs are directly applicable (self-executing) and therefore require no domestic implementation, see REICH, § 3 N 14.

[134] Art. 10(2) OECD-MC. These rules shall not apply if the beneficial owner of the dividends carries on business in the state in which the company paying the dividends is a resident through a permanent establishment and the holding, in respect of which the dividends are paid, is effectively connected with such permanent establishment, see art. 10(4) OECD-MC.

[135] OECD-MC, Commentary 2017, art. 10 N 18. Regarding the withholding tax policy of developing and industrialised countries for cross-border interest payments, see JEHLIN, p. 155 et seq.

[136] Art. 10(2)(a) OECD-MC.

[137] See, for examples, art. 11(2)(b)(i) DTA CH-F and art. 10(2)(a)(i) DTA CH-UK, in which the taxation right is excluded in case of direct or indirect participation of 10%.

[138] MEISTER, p. 123; HOHMANN/MÜLLER, p. 654.

[139] Art. 10(3) OECD-MC.

includes interest on loans when the lender effectively shares the risks run by the company, i.e. when repayment depends mostly on the success or otherwise of the enterprise's business.[140] This condition is given, for examples, when (i) the loan very heavily outweighs any other contribution to the enterprise's capital and is substantially unmatched by redeemable assets, (ii) the creditor shares any profits of the company, (iii) repayment of the loan is subordinated to claims of other creditors or to the payment of dividends, (iv) the level or payment of interest depends on the profits of the company or (v) the loan contract contains no fixed provisions for repayment by a definite date.[141]

3.3.2 Debt Financing

Similarly to dividend payment, article 11(1) OECD-MC gives taxation right on interests to the recipient's state of residence. According to the OECD-MC, but not in the DTAs concluded with Germany, France, Austria, the UK and the US, taxation right on interests is also allocated to the source state.[142] As for equity financing, the source state is free to apply its laws and to levy the tax either by deduction at source (withholding tax) or by individual assessment.[143] Nonetheless, if the beneficial owner of the interest is a resident of the other state, the tax so charged shall not exceed 10% of the gross amount of the interest.[144] According to the article 9(2) of the Agreement between Switzerland and the EU on the automatic exchange of information on financial accounts (AEOI CH-EU)[145], interests paid between associated companies with tax residence in the EU and Switzerland shall not be taxed in the source state.[146]

According to the definition of article 11(3) OECD-MC, the term *interest* means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.[147] Interest on participating and convertible loans or bonds are generally not considered as a dividend, except if the loan effectively shares the risks run by the debtor company.[148] Articles 10 and 11 OECD-MC do not prevent the treatment of this type of

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[140] OECD-MC, Commentary 2017, art. 10 N 25.

[141] OECD-MC, Commentary 2017, art. 10 N 25.

[142] Art. 11(2) OECD-MC. See art. 11(1) DTA CH-D; art. 12(1) DTA CH-F; art. 11(1) DTA CH-A; art. 11(1) DTA CH-UK; art. 11(1) DTA CH-USA. See also art. 11(4) OECD-MC if the beneficial owner of the interest carries on business through a permanent establishment in the state in which the interest arises. Regarding the definition of source state, see art. 11(5) OECD-MC.

[143] OECD-MC, Commentary 2017, art. 11 N 12.

[144] Art. 11(2) OECD-MC. On the justification of this limit, see MARTINHO FERNANDES, p. 37.

[145] In this regard, see also the Federal Act on the Agreement of Interest Taxation with the European Community (SR 641.91).

[146] Direct participation of at least 25 % for at least two years is necessary. Further companies must be subject to corporate income tax without exemption.

[147] The article specifies that penalty charges for late payment shall not be regarded as interest.

[148] OECD-MC, Commentary 2017, art. 11 N 19; KOPP, p. 858. Regarding the tax treatment of other hybrid financing instruments in international tax law, see MEISTER, p. 97 et seq.; PRATTER/EICHENBERGER, p. 650 et seq.; HONGLER, Finanzierungsinstrumente, p. 284 et seq.

interest as dividends under the national rules on thin capitalisation applied in the borrower's country.[149]

Unlike in Swiss domestic tax law and even if the commercial law classification as equity or debt also serves as a starting point, the economic substance of the financing can lead to a reclassification of the financing in international tax law.[150] However, according to the literature, Swiss tax authorities are generally reluctant to apply autonomous treaty interpretation and they are more likely to apply article 11 of the respective DTA to incomes considered as interests for domestic tax purposes.[151]

4 Swiss Interest Limitation Rules prior to BEPS Action 4

This chapter aims to examine the Swiss thin capitalisation rules before BEPS Action 4. For this purpose, the general principles (section 4.1) and the thin capitalisation rules themselves (section 4.2) will be outlined. Their concretisation, the federal tax administration's guidance, will then be exposed (section 4.3) and a focus will be put on the personal scope of the rules (section 4.4). The determination of relevant thin capitalisation will be explained along with a concrete example (section 4.5) and the tax consequences of thin capitalisation will be presented (section 4.6). Finally, the relevant case law will be discussed (section 4.7).

4.1 General Principles

Commercial law does not contain any provisions on the equity capital required to achieve the business purpose of a company, nor does it contain any provisions on the balance of its equity capital in relation to debt capital.[152] It is generally left to shareholders to provide their company with sufficient equity and to determine the ratio between equity and debt.[153] As outlined above, form a tax perspective, debt financing appears to be more advantageous than equity financing because of the absence of economic double taxation, stamp duty and withholding tax as well as because of the deductibility of interests.[154] The potential excessive debt financing (undercapitalisation) is therefore restricted by tax law to the extent that companies cannot reduce the income, capital and/or withholding tax substrate as they wish by taking exclusively

[149] OECD-MC, Commentary 2017, art. 10 N 25; HONGLER, Finanzierungsinstrumente, p. 289 et seq.; HOHMANN/MÜLLER, p. 657. However, the particular wording of the DTA might deviate from the OECD-MC, see for example art. 10(4) DTA CH-D.

[150] This is not the case in the very formal domestic classification as equity or debt financing in Switzerland. See KOPP, p. 867 et seq.

[151] There is however no explicit case law available. See BSK OECD-MC-WEIDMANN, art. 11 N 3 et seq.; BÖHI/HONGLER, p. 678.

[152] FORSTMOSER/MEIER-HAYOZ/NOBEL, § 40 N 344; STÖCKLI, p. 662.

[153] FORSTMOSER/MEIER-HAYOZ/NOBEL, § 1 N 50; BSK OR II-BAUDENBACHER, Art. 621 N 1. This is different for banks and insurance companies, which are subject to (increasingly stringent) regulatory requirements requiring risk-adjusted equity financing.

[154] CR LIFD-DANON, art. 65 N 3 FDTA; KUHN/SIDLER, p. 1021. BOHN, p. 12 et seq. comes to the same conclusion in Germany. Debt financing is also preferential from an economic point of view, see the pecking order theory.

interest-bearing debt instead of non-interest-bearing equity.[155] Tax legislators are using a multitude of different approaches to limit the deductible interest expense.[156] They generally either rely on thin capitalisation rules based on general tax principles (such as the anti-avoidance legislation, the *substance over form* approach or the arm's length principle), on specific rules (such as debt-to-equity ratios or earnings stripping rules) or a mix of them.[157] Switzerland does not have fixed ratio provisions limiting the deductibility of interest payments. Nonetheless, Switzerland applies thin capitalisation rules, which indirectly limit the deductibility of interest payments through reclassification of excessive debt capital in deemed (hidden) equity capital. The following sections outline the main aspects of these rules.

4.2 Swiss Thin Capitalisation Rules

In Switzerland, the thin capitalisation rules are set out in article 65 FDTA for federal corporate income tax purposes and in article 24(1)(c) in conjunction with article 29*a* FTHA for cantonal corporate income and capital tax purposes.[158] According to the Swiss Supreme Court, these provisions need interpretation.[159] Following the practice of the Swiss Supreme Court, a pluralism of methods is to be used to interpret the (tax) law: (i) grammatical, (ii) historical, (iii) systematic and (iv) teleological elements must be taken into account.[160]

4.2.1 Grammatical Interpretation

Both federal and cantonal wordings are the same. Pursuant to articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA: "The taxable profits of corporations and cooperatives shall also include the interest owed on the portion of borrowed funds which economically correspond to equity capital".[161] According to the wording, it is irrelevant whether the company is undercapitalised; only the quality of the financing is relevant.[162] The interpretation of the law thus requires an economic approach: one needs to determine whether the borrowed funds *economically correspond* to equity capital. The debt under scrutiny needs to have the relevant functions of equity to justify reclassification.[163] In other words, the civil law point of reference alone is not decisive and a *substance over form* approach needs to be adopted.[164]

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[155] BÖHI, verdecktes Eigenkapital, p. 109 et seq.; LOCHER, art. 65 N 2 FDTA; HÖHN/WALDBURGER, Band I, § 19 N 10; VON SALIS-LÜTOLF, p. 173; BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 3.

[156] The reason for this is that the determination of appropriate leverage cannot be derived theoretically or empirically. See MARTINHO FERNANDES, p. 46.

[157] MARTINHO FERNANDES, p. 26 et seq.; BOHN, p. 157 et seq.; MASSBAUM, p. 15 et seq.

[158] Some minimal deviations exist between cantonal provisions and art. 24(1)(c) and 29*a* FTHA but they do not appear to be of material importance, see HONGLER/BÖHI, p. 129.

[159] BGer 30 September, 2015 (2C_560/2014), cons. 3.3.1.

[160] BGE 138 II 557, cons. 7.1; REICH, § 6 N 16. Moreover, the economic criteria are also of significance since the thin capitalisation rules include an economic component, see BGE 115 Ib 238, cons. 3b.

[161] Regarding the question of whether this rule is a complement to the deemed profit distribution provisions or a separate tax correction norm, see HONGLER, Finanzierungsinstrumente, p. 52 et seq.

[162] HONGLER, Finanzierungsinstrumente, p. 58.

[163] VON SALIS-LÜTOLF, p. 178 et seq.; BÖHI/HONGLER, p. 684. See section 3.1.1.

[164] ROBINSON/WIPFLI, p. 75; HONGLER/BÖHI, p. 128; LOCHER, art. 65 N 9 FDTA.

4.2.2 Historical Interpretation

The aforementioned articles entered into force on 1 January, 1998. Prior to their introduction, the tax authorities and courts examined, at least for direct federal tax purposes, the amount of debt financing based on the general tax evasion provision.[165] In the current terminology, the Swiss thin capitalisation rules would, therefore, qualify as specific anti-avoidance rules (SAAR).[166] Interestingly, the first draft of these articles explicitly stated that the equity ratio (equity divided by assets) should amount to at least one-third for real estate companies and one-sixth for financing companies.[167] However, such special rule for financing and real estate companies was deleted in the legislative procedure and the articles entered into force essentially in the same wording, which is currently still applicable.[168] Therefore, the will of the legislator seems to be that the amount of debt financing alone is not decisive. Rather, one should examine whether debt financing has the economic significance of equity capital.[169] One should also note that these provisions on thin capitalisation were not introduced primarily to prevent the outflow of tax substrate abroad, but rather to limit the avoidance of the economic double taxation.[170] Indeed, debt financing is assessed equally, regardless of whether it originates from a domestic or foreign investor. Accordingly, the legislator targeted structures in which shareholders could reduce taxation at the company level and at their level by granting loans to their company.[171] Further, the legislative documentation clearly states that only the part of the borrowed funds that the company could not collect by its own efforts from third-party shareholders, under otherwise identical conditions, are to be added to equity.[172]

4.2.3 Systematic Interpretation

From a systematic point of view, article 65 FDTA is part of the section relating to corporate income tax and, more precisely, to the calculation of the net taxable profit. It, therefore, does not apply to self-employed tax subjects, even if they maintain proper commercial accounts.[173] Article 65 FDTA is designed as a tax correction provision, which adds back to the balance of the income statement (established according to commercial law) the interest owed on deemed (hidden) equity capital.

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[165] BGer 30 September, 2015 (2C_560/2014), cons. 2.1.3. See e.g. BGE 90 I 217, cons. 2. Therefore, the tax authorities had to prove the tax evasion, which is not the case anymore, see SFTA-Circular 6, p. 1. For the conditions of the general tax evasion under Swiss law, see BGE 131 II 627, cons. 5.2.

[166] HONGLER/BÖHI, p. 129.

[167] Message Tax Harmonisation, p. 355.

[168] BÖHI/HONGLER, p. 684.

[169] HONGLER/BÖHI, p. 129; BÖHI, verdecktes Eigenkapital, p. 151.

[170] BÖHI, Übersicht, p. 179; BÖHI, verdecktes Eigenkapital, p. 115 et seq.; HONGLER, Finanzierungsinstrumente, p. 57; BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 3.

[171] HONGLER/BÖHI, p. 129.

[172] Message Tax Harmonisation, p. 129 et seq.

[173] See art. 18 et seq. FDTA and art. 8 and 10 FTHA.

4.2.4 Teleological Interpretation

The Swiss thin capitalisation rules have mainly three purposes. Firstly, they aim at securing the economic double taxation, which includes the prevention of misusing the financing freedom.[174] Indeed, a disproportionate amount of debt financing from shareholders or related parties allows them to receive a high share of the profits through deductible debt interest and reduces the capital tax base. Secondly, the thin capitalisation rules strive for the equal tax treatment of profit-oriented companies so that economically unreasonable debt financing by a shareholder or related parties is classified as deemed equity regardless of their market interest rates.[175] In this regard, the thin capitalisation rules limit the tax advantage of debt compared to equity financing.[176] Thirdly, even if it was not historically the main objective, the thin capitalisation rules seek to limit base erosion and profit shifting through interest deduction in cross-border or intercantonal circumstances.[177] In particular, the incentive of foreign shareholders to provide Swiss company with as much debt capital as possible to repatriate funds in the form of interests instead of dividends subject to withholding tax must be limited.[178] Following an economic approach, the debt capital must have the economic functions of equity[179] to justify a tax reclassification as deemed equity, whereas it is nonetheless not necessary that the investors have voting rights.[180] The lender must be placed on the same economic footing as the shareholder and must assume entrepreneurial risks. For example, a reclassification would be possible if the debt is convertible in equity (liability function), does not contain a repayment obligation (continuity and existence function), is directly affected by a negative (loss compensation function) or a positive (profit participation function) company result and if the lender has possibilities to influence the course of business (control function). All economic aspects of the individual situation have to be taken into account to determine whether a reclassification as deemed equity could happen.[181]

4.3 Federal Tax Administration's Safe Haven Approach

In order to provide legal certainty to taxpayers, the SFTA published on 6 June, 1997 safe haven rules (officially called Circular No. 6) related to the application and interpretation of the

[174] BÖHI/HONGLER, p. 679; MÜLLER, N 261; CR LIFD-DANON, art. 65 N 2 FDTA.

[175] BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 3; LOCHER, art. 65 N 2 FDTA; VON SALIS-LÜTOLF, p. 173; HÖHN/WALDBURGER, Band I, § 19 N 10; BGer 6 November, 2008 (2C_259/2008), cons 2.5.1.

[176] BÖHI, verdecktes Eigenkapital, p. 118 et seq.

[177] BÖHI, verdecktes Eigenkapital, p. 119.

[178] This incentive is even greater if Switzerland does not have a DTA with the shareholder's country of residence.

[179] See section 3.1.1. These functions are namely the continuity and existence, loss compensation, liability, profit participation and control functions.

[180] HONGLER, Finanzierungsinstrumente, p. 61. See BÖHI, Übersicht, p. 180 and BÖHI, verdecktes Eigenkapital, p. 163 who mention the lack of debt features as a condition for the reclassification.

[181] LOCHER, art. 65 N 14 FDTA.

thin capitalisation rules presented in the previous section.[182] Such circular also has the goal to ensure the consistent application of the law across the cantons, as they are responsible for the assessment and the collection of the federal corporate tax.[183] From a legal point of view, circulars are considered as administrative ordinances and represent the opinion of the tax authority.[184] If they do not contain any content that is unconstitutional or illegal, they are binding on the administrative authorities concerned.[185] However, they are not binding on judicial authorities, which must check that the administrative ordinances comply with the law and the Constitution.[186]

Concretely, the Circular No. 6 calculates the maximum amount of debt the company can obtain from related parties and the related maximum interest capacity.[187] It aims at giving an indication of the average debt capital available on the free financing market.[188] For this purpose, it contains specific asset/debt ratios, whereas the relevant underlying value of the assets is generally the market value unless higher fair values can be demonstrated.[189] According to Circular No. 6, the maximum debt allowed for finance companies is generally six sevenths of the total assets.[190] Other companies will be considered by the tax authorities to be able to obtain by their own means debt capital up to the following percentages:

– Cash:	100%	– Non-quoted shares:	50%
– Accounts receivable:	85%	– Investments in subsidiaries:	70%
– Inventory:	85%	– Loans:	85%
– Other current assets:	85%	– Furniture and equipment:	50%
– Bonds in CHF:	90%	– Property, plant (commercially used):	70%
– Bonds in foreign currency:	80%	– Other real estates:	80%
– Quoted shares:	60%	– Intellectual property rights:	70%

Table 1: Percentages of Debt allowed according to Types of Assets[191]

[182] BÖHI, verdecktes Eigenkapital, p. 214; VOCK/NEF, Teil 2, p. 355. Regarding the difference between a fixed ratio and a safe haven rule, see MARTINHO FERNANDES, p. 44.

[183] BÖHI, Übersicht, p. 180. See art. 102(2) FDTA, art. 128(4) FC and art. 2 FDTA.

[184] HAMELIN/MÜLLER/ULLMAN, N 123; BAUSCH, art. 102 DBG N 9; REICH, § 3 N 34 et seq.

[185] BGE 122 V 249, cons. 4; BEUSCH, art. 102 DBG N 15 et seq.

[186] BGE 126 II 275, cons. 4; BGE 123 II 16, cons. 7; BÖHI, verdecktes Eigenkapital, p. 215. See section 2.1.

[187] BÖHI/HONGLER, p. 680.

[188] BÖHI, verdecktes Eigenkapital, p. 215; BÖHI/HONGLER, p. 680.

[189] SFTA-Circular 6, p. 2. For reasons of practicability, however, the tax authority bases itself on the values determining the corporate income tax (book values). However, higher fair values can be proved by the taxable company. See MÜLLER, N 264.

[190] SFTA-Circular 6, p. 2.

[191] Own representation, based on SFTA-Circular 6, p. 2.

The asset/debt ratio for other types of assets must be determined according to a debt capacity analysis and/or must be agreed upon with the tax authority.[192] Based on these ratios, the maximum admissible amount of debt that should theoretically be available from the company's own resources is calculated. As long as the debts on the taxpayer's balance sheet stay within those safe haven rules, they cannot be reclassified as deemed equity.[193] However, to the extent that the reported debt capital exceeds the admissible debt capital, deemed equity is assumed, whereby only that part is considered deemed equity which originates directly or indirectly from shareholders or persons related to them.[194] If debt capital is made available by independent third parties without security from the shareholders or persons related to them, there is no deemed equity.[195] The reason of this limitation of the personal scope lies in the legislator's intent to prevent the avoidance of double economic taxation.[196] Besides, the taxpayer can prove that the specific financing is at arm's length, i.e. that an independent third party would have granted it to the same extent and under the same circumstances.[197] In such case, there is no deemed equity, even if the admissible debt capital calculated based on Circular No. 6 is exceeded.[198] The safe haven approach is generally recognised as a reasonable solution and it is also widely applied by most cantons.[199]

4.4 Personal Scope and Relevant Lenders

The safe haven guidance of the SFTA applies to every taxpayer whose balance sheet's assets correspond predominantly to those listed in the Circular No. 6, such as industrial companies, real estate companies, head office companies, investment companies or finance companies.[200] However, it does not apply to taxpayers from other sectors, whose assets do not fit into the asset types listed in Circular No. 6 or who are subject to special regulatory rules regarding their capital requirements (e.g. banks and insurances).[201] According to their respective wordings, articles 65 FDFA and 29*a* FTHA not only encompass Swiss companies [202] but also Swiss cooperatives. Unlike transparent collective investment schemes (such as contractual funds or SICAV), Swiss investment companies with fixed

[192] BÖHI, verdecktes Eigenkapital, p. 261 et seq.; BÖHI/HONGLER, p. 680.
[193] BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 58; ROBINSON/WIPFLI, p. 68.
[194] SFTA-Circular 6, p. 2. See HONGLER, Finanzierungsinstrumente, p. 58.
[195] BOHN, p. 153.
[196] BGE 120 II 331, cons. 5. See also HONGLER, Finanzierungsinstrumente, p. 59.
[197] SFTA-Circular 6, p. 2.
[198] SFTA-Circular 6, p. 2; HONGLER/BÖHI, p. 130 and the references.
[199] BÖHI, verdecktes Eigenkapital, p. 218 et seq. and p. 265 et seq.; BÖHI/HONGLER, p. 681. Very few cantons have published different safe haven rules.
[200] BÖHI, Übersicht, p. 181. Concerning real estate companies, see also BURKI, p. 112 et seq.
[201] BÖHI, Übersicht, p. 181. See e.g. for banks the Ordinance concerning Capital Adequacy and Risk Diversification for Banks and Securities Traders (SR 952.03).
[202] I.e. limited partnership (art. 594 et seq. CO), company limited by shares (art. 620 et seq. CO) and limited liability companies (art. 772 et seq. CO).

capital (SICAF) are also subject to thin capitalisation rules.[203] The same applies to Swiss branches of legal entities subject to unlimited taxation in Switzerland. In contrast, Swiss branches of entities subject to (limited) taxation based on *economic affiliation* in Switzerland are not subject to Swiss thin capitalisation rules.[204] The same applies to Swiss associations, foundations, partnerships and other legal entities.[205] As outlined above, self-employed taxpayers are also not concerned by the thin capitalisation rules, even if they maintain proper commercial accounts.[206]

Unlike some foreign tax laws, the Swiss thin capitalisation rules do not distinguish between national and international situations, i.e. the tax domicile of the lender is irrelevant.[207] These rules are therefore applicable to both international as well as domestic debts. As it is generally the case in Swiss Law, no specific rules exist when the thin capitalisation provisions are applied to group companies. The analysis according to the SFTA's safe haven approach is conducted at the level of each legal entity. As mentioned above, independent third party debt, which is not secured by a related party, does not fall into the scope of the thin capitalisation rules.[208] Only shareholders or persons related to them qualify as potentially harmful lenders. According to BÖHI, it can be assumed that persons are related to each other when their interests are not totally opposed, e.g. as a result of close economic, personal or family ties.[209] More generally, a related person is any person who benefits from advantages which would not usually be granted to third parties and whose cause is to be found in the ties – of whatever nature – between the shareholder and the related person.[210] Both individuals and legal entities can qualify as persons related to the shareholders.[211]

[203] Art. 49(2) FDTA and art. 20(1) FTHA.
[204] BÖHI, verdecktes Eigenkapital, p. 203 et seq.
[205] Art. 65 in connection with 49(1)(b) FDTA *e contrario*. See BÖHI, verdecktes Eigenkapital, p. 198 et seq.
[206] See section 4.2.3.
[207] BÖHI, verdecktes Eigenkapital, p. 121.
[208] See BGE 142 II 355, cons. 7.1; SFTA-Circular 6, p. 2. For example, see OESTERHELT, verdecktem Eigenkapital, p. 1005.
[209] BÖHI, verdecktes Eigenkapital, p. 236.
[210] MONTAVON, p. 145.
[211] BÖHI, verdecktes Eigenkapital, p. 241.

4.5 Determination of Relevant Thin Capitalisation

The determination of the maximum admissible debt capital for tax purposes, respectively the existence of deemed equity capital, as well as the associated maximum admissible interest expense can be carried out in five steps. It will be illustrated in the present section with the example of a company whose balance sheet is as follows:

Assets (in kCHF)		**Liabilities and Equity (in kCHF)**	
Cash	50	Accrued expenses	50
Quoted shares	450	Bank loan	75
Investments in subsidiaries	250	Interest-bearing (10%) intercompany loan	700
Real estate	250 (300 MV)	Non-interest-bearing intercompany loan	75
		Common stock	100
	1000		1000

Table 2: Example of a Balance Sheet[212]

The first step is to determine to what extent debt capital can be reclassified as deemed equity, i.e. the relevant debt capital must be specified and it must be clarified as to whether it originates from harmful lenders. As mentioned, deemed equity only exists if the debt capital originates directly or indirectly from shareholders or persons related to them. Further, according to the literature, non-interest-bearing debt, independently from its origin, should be considered as relevant for capital tax purposes but not for corporate income tax purposes.[213] Indeed, it is assumed that the debt from independent third parties is only available to the company against interest.[214]

In casu, the accrued expenses are first to exclude because they obviously cannot economically correspond to equity capital. The bank loan typically flows from an independent third party and because it cannot be classified as deemed equity, it should also not be taken into account.[215] According to the previous explanations, the non-interest-bearing intercompany loan will be included in the relevant debt capital from harmful lenders for capital tax purposes although it does not imply any interest expense for the company. The interest-bearing intercompany loan, which assumedly originates from the parent company (that used its influence to arrange a 10% interest), qualifies also as relevant debt capital from harmful

[212] Own representation.

[213] BÖHI, verdecktes Eigenkapital, p. 231 et seq. Of another opinion: VOCK/NEF, Teil 1, p. 272.

[214] BÖHI, verdecktes Eigenkapital, p. 231 et seq.

[215] The tax authorities would have to prove a tax evasion to reclassify the bank loan as deemed equity. See BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 22 et seq.

lenders.[216] The determination of the relevant debt capital from harmful lenders looks, therefore, as follows:

Accrued expenses	CHF 0
Bank loan	CHF 0
Interest-bearing (10%) intercompany loan	CHF 700,000
Non-interest-bearing intercompany loan	CHF 75,000
Relevant debt capital from harmful lenders	CHF 775,000

Table 3: Calculation of Relevant Debt Capital[217]

The second step consists in determining the maximum debt capacity based on the percentages of assets specified in Circular No. 6.[218] As mentioned, the calculation is derived from the assets' market value.[219] *In casu*, because the real estate was bought a long time ago, it is known that its market value is CHF 300,000, i.e. CHF 50,000 more than its book value of CHF 250,000. Therefore, CHF 300,000 must be taken into account for the real estate. The maximum debt capacity from related parties amounts to:

Assets	**Market value**	**% Circ. 6[220]**		
Cash	CHF 50,000	100%	=	CHF 50,000
Quoted shares	CHF 500,000	60%	=	CHF 300,000
Investments in subsidiaries	CHF 150,000	80%	=	CHF 120,000
Real estate	CHF 300,000	70%	=	CHF 210,000
Maximum debt capacity from related parties				CHF 680,000

Table 4: Calculation of Maximum Debt Capacity from Related Parties[221]

[216] According to the practice of the Federal Supreme Court, the only decisive factor for qualification as a related party is whether a corresponding payment is made to the person concerned because the shareholder wants it. This would mean that in case the loan would be granted by the sister company because the parent company wants it, the loan would also mostly qualify as relevant debt capital from harmful lenders. In tax practice, all intercompany debts (both interest-bearing and non-interest-bearing) are generally taken into account, see HONGLER/BÖHI, p. 130.

[217] Own representation.

[218] This maximum debt capacity can also be determined with other economic procedures, see BÖHI/HONGLER, p. 681. This is, however, rather the exception and very often the maximum debt capacity is calculated with Circular No. 6.

[219] The taxpayer must provide evidence of the market value. For reasons of practicability, the tax authorities will otherwise assume tax values. See BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 54; LOCHER, art. 65 N 21 FDTA.

[220] See SFTA-Circular 6, p. 2.

[221] Own representation.

The third step aims to determine whether deemed equity exists. Deemed equity capital is assumed to exist if the company's relevant debt capital from harmful lenders exceeds the funds available from its own resources following Circular No. 6.[222] *In casu*, this is the case as the relevant debt capital amounts to CHF 775,000 and is higher than the maximum debt capacity from related parties, which amounts to CHF 680,000. Therefore, hidden capital is assumed to be CHF 95,000 (CHF 775,000 – CHF 680,000).

The fourth step is to check whether the interest expense is justified by business reasons and can be claimed as a tax deduction. The maximum interest capacity is to be calculated and compared with the actual interest expense. Accordingly, the maximum allowed debt capital from related parties is multiplied by the safe haven interest rates published annually by the SFTA. For 2019, for operating loans up to one million CHF in trade and industry, the safe haven interest rate amounts to 3%.[223] *In casu*, the situation looks as follows:

Actual interest expense:	CHF 700,000 * 10%	= CHF 70,000
Maximum interest capacity:	CHF 680,000 * 3%	= CHF 20,400
Exceeding interest expense:		**CHF 49,600**

Table 5: Calculation of Exceeding Interest Expense[224]

In our case, the company pays interest rates (i.e. 10%) that exceed the safe haven interest (i.e. 3%). In such a case, the tax deductibility of the sum of recognised debt times the safe haven interest rate (i.e. the maximum interest capacity) will be granted. However, the exceeding interest expense, even if partially paid on the recognised debt, will not be deductible (so-called calculatory method).[225] *In casu*, the tax deductibility will therefore not be granted to an amount of CHF 49,600.[226] In case the company would pay safe haven interests (i.c. 3%) and not 10% on the intercompany loan, the tax deductibility would only be refused on the part exceeding the maximum debt capacity (i.c. CHF 20,000).[227]

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[222] HONGLER/BÖHI, p. 130.

[223] SFTA-Circular Letter CHF, p. 2. Regarding remuneration for advances or loans granted in foreign currencies, see SFTA-Circular Letter FCY, p. 1. STURZENEGGER/BONVIN, p. 628 point out the fact that these annual safe haven interests are not practicable for companies willing to conclude long term loans.

[224] Own representation.

[225] BGer 15 January, 2018 (2C_443/2017), cons. 4.3; BGer 26 April, 2006 (2P.338/2004; 2A.757/2004/svc); SFTA-Circular 6, p. 3.

[226] Regarding the further consequences of deemed equity, see section 4.6.

[227] BÖHI/HONGLER, p. 682. The sum of the safe haven interest rate times the recognised debt is considered as the maximum amount tax deductible interest expense. See SFTA-Circular 6, p. 3; DURANT, p. 33.

As a fifth step, the taxpayer can still prove that the interest rate applied in its particular case is at arm's length.[228] For this purpose, the taxpayer must set out all the relevant facts and circumstances to prove that the interest rate it pays on the relevant debt capital from harmful lenders respects the arm's length principle. *In casu*, therefore, if the taxpayer can show that a *concrete* independent third party would have been willing to take such a 10% interest rate loan to the same extent and with the same conditions as granted, no reclassification would occur.[229]

4.6 Tax Consequences of Thin Capitalisation

If the relevant debt capital from harmful lenders exceeds the maximum debt capacity from related parties, then it lies deemed equity capital within the meaning of article 65 FDTA and 24(1)(c) in connection with 29*a* FTHA. As a consequence, the deemed equity is added to the taxable equity of the borrower for capital tax purposes.[230] In doing so, deemed equity is treated as paid-up share capital and not as reserves.[231] Therefore, a loss carried forward can not be compensated by deemed equity capital.[232] The repayment of debt capital considered as deemed equity to shareholders and persons related to them is not taxable.[233]

The non-deductible interest expense on deemed equity, i.e. the interest expense on debt funded by related parties above the maximum interest capacity, is reclassified as deemed or hidden[234] profit distributions (dividend) and added back to the taxable net profit of the borrower.[235] According to the practice of the SFTA, the non-deductible interest expenses are therefore considered as earnings on participation according to articles 70 FDTA as well as 28(1) and 28(1bis) FTHA.[236] The reclassification as deemed profit distributions can, especially in the case of small and person-related companies, also lead to accusations of (attempted) tax evasion and trigger criminal law consequences.[237] As for the lender, the received interest is

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[228] See BSK FDTA-BRÜLISAUER/MÜHLEMANN, art. 58 N 254; VOCK/NEF, Teil 1, p. 277; STURZENEGGER/BONVIN, p. 626 et seq. For large companies, the market interest rates can be calculated based on the company's credit rating, see DEJARDIN, p. 143 et seq.

[229] A hypothetical arm's length comparison is also possible. In that case, the amount and the conditions of the debt must be examined to determine whether it offers a risk/return ratio in line with the market, see BÖHI, verdecktes Eigenkapital, p. 271. Regarding credit assessment criteria, see SCHMID, Ermittlung, p. 224 et seq.

[230] See SFTA-Circular 6, p. 3; CR LIFD-DANON, art. 65 N 11 FDTA.

[231] BÖHI, verdecktes Eigenkapital, p. 290.

[232] SFTA-Circular 6, p. 3.

[233] SFTA-Circular 6, p. 3.

[234] The term "hidden" profit distribution opposes to "open" profit distribution, which has been approved by the general meeting of shareholders, see HONGLER, Finanzierungsintrumente, p. 99. Regarding the general conditions of hidden profit distribution, see BÖHI, verdecktes Eigenkapital, p. 86 et seq.

[235] SFTA-Circular 6, p. 3; BOHN, p. 153. The interest on ordinary debt that is above arm's length will also be added to the net income in accordance with art. 58(1)(b) FDTA and 24(1)(c) FTHA.

[236] SFTA-Circular 27, 2.4.1, p. 4; HONGLER, Finanzierungsinstrumente, p.107. Interests on deemed equity should also be taken into account when calculating the profit participation rate pursuant to art. 69(b) FDTA and 28(1bis) FTHA.

[237] See MARGRAF, p. 6 et seq.

taxed as a dividend, i.e. as income from movable assets for individuals and as income for any legal entity or individuals who granted the debt for business purposes.[238] Further, individuals might be entitled to the privilege under articles 20(1bis) FDTA and 7(1) FTHA if deemed equity represents at least 10 % of the share capital.[239]

Non-recognised interest expenses, like any other profit distributions, are subject to the 35% withholding tax.[240] The withholding tax must be paid spontaneously to the SFTA within 30 days after the maturity of such profit distribution.[241] If the maturity date is not set for the profit distribution, the SFTA would argue that the 30 days period begins on the day on which the profit is distributed.[242] If the SFTA receives no declaration in time, it can impose an administrative fine of up to CHF 5,000.[243] From the maturity date, the SFTA would also levy a late payment interest of 5% per annum.[244] If the withholding tax is not charged to the recipient, then the SFTA adjusts the tax basis (if the net payment is 100, then the tax basis would be 153.84 (100 / 100 * 65)) as well as the tax rate (53.8% instead of 35%) and taxes directly the distributing company.[245] In case a Swiss company is holding at least 20% of the share capital of the distributing subsidiary, the latter can proceed to the payment without deduction of withholding tax using an official form (unilateral notification procedure).[246] As outlined in section 2.3.5, Swiss recipients are entitled to reimbursement of the deducted withholding tax, given they are the beneficial owner of the taxable benefits and declare the related income and assets for income and capital tax purposes.[247] Individuals and entities without tax liability in Switzerland can only apply for (partial or full) reimbursement based on international tax treaties, whereas the fact that the country of residence does not add the deemed profit distribution to the taxable income of the shareholder does not preclude a refund of the withholding tax.[248]

The conversion of deemed equity in taxable equity, as well as the other corporate tax adjustments relating to thin capitalisation, are only carried out for tax purposes and are not also reconstructed under commercial law.[249] The question of whether deemed equity capital

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[238] Art. 20(1)(c) FDTA and 7(1) FTHA; art. 18(1) and 57 FDTA as well as 8(1) and 24(1) FTHA.

[239] OESTERHELT, verdecktem Eigenkapital, p. 1006.

[240] Art. 4(1)(b) in connection with art. 13(1)(a) WHTA.

[241] Art. 21(2) WHTO. See also art. 16(1)(c) WHTA. Regarding the reimbursement of withholding tax to foreign finance companies, see BÖHI, verdecktes Eigenkapital, p. 122 et seq.

[242] Art. 21(3) WHTO.

[243] Art. 20(3) WHTA in connection with art. 64 WHTA.

[244] Art. 16(2) WHTA in connection with art. 1(1) Ordinance on late payment interest on withholding tax (SR 642.212).

[245] SFTA-Withholding tax information, N 4.3 p. 15; MONTAVON, p. 146.

[246] Art. 20 WHTA and art. 26*a*(1) WHTO.

[247] Art. 1(2) and 21 to 28 WHTA.

[248] OESTERHELT, verdecktem Eigenkapital, p. 1008. If the DTA assigns the right to tax the dividends exclusively to the state of residence, foreign legal entities can claim full reimbursement or apply for the unilateral notification procedure.

[249] HONGLER, Finanzierungsinstrumente, p. 56.

exists must be re-examined on the occasion of each assessment.[250] Further, the SFTA does not levy the one-time stamp duty of 1% on the non-recognised debt as no new shares are created; respectively, no increase of the par value of participation rights is triggered.[251] To the extent that the debt would, however, be swapped into "real equity", the 1% charge would be due unless a financial restructuring exemption applies.[252]

4.7 Case Law

Before articles 65 FDTA and 29*a* FTHA came into force, the Swiss Supreme Court repeatedly dealt with the concept of deemed equity or expressed its opinion on excessive debt financing.[253] After these provisions came into force, however, the Swiss Supreme Court rendered substantially fewer judgments.[254] The following is an overview of the relevant jurisprudence on deemed equity:

- The existence of deemed equity capital no longer requires the tax evasion conditions to be fulfiled.[255]
- The asset/debt ratio for real estate according to Circular No. 6 does not depend on whether the company has rent the properties or uses them for its own needs.[256]
- For capital tax purposes, the deemed equity capital can compensate for an adverse balance because it cannot be considered equivalent to the paid-up share capital.[257]
- Although subordinated debt from shareholders can be regarded as "quasi-equity" from an economic point of view, it does not by default re-qualify as deemed equity but the general thin capitalisation rules have to be applied.[258]
- No consolidated approach is taken when it comes to the determination of tax-deductible interest rates.[259]

In a judgment of 30 September, 2015, the Swiss Supreme Court stated that, for the calculation of the maximum (deductible) interest capacity, no conversion of the annual

[250] BÖHI, verdecktes Eigenkapital, p. 284 et seq.
[251] BÖHI, verdecktes Eigenkapital, p. 291; art. 5 SDA *a contrario*; HONGLER, Finanzierungsinstrumente, p. 74; BSK SDA-TADDEI/FELBER, art. 5, N 61.
[252] Art. 6(1)(k) and 12 SDA; BÖHI/HONGLER, p. 686.
[253] For the references, see BÖHI, verdecktes Eigenkapital, p. 167 et seq.; BURKI, p. 71 et seq.; WEIDMANN, p. 328; SCHMID, Ermittlung, p. 212 et seq.
[254] According to BÖHI, verdecktes Eigenkapital, p. 171 this is because both provisions, as well as the Circular No. 6, increased the legal certainty.
[255] BGer 26 April, 2006 (2P.338/2004), cons. 4.2.
[256] BGer 26 April, 2006 (2P.338/2004), cons. 6.2.
[257] BGer 6 November, 2008 (2C_259/2008), cons. 2.5.3.
[258] BGer 31 August, 2012 (2C_77/2012), cons. 2.3 and 3.4. See also BÖHI, verdecktes Eigenkapital, p. 232 et seq.
[259] See BGer 15 January, 2018 (2C_443/2017), cons. 4.3 and BGer 10 August, 2015 (2C_1108/2014), cons. 2.3.

accounts in the presentation currency (*in casu* CHF) is required.[260] The calculation of the maximum interest capacity should be based on the accounts in the functional currency.[261] The Swiss Supreme court explained that the assessment of whether deemed equity capital exists must follow an economic logic and that currency conversions should not distort it.[262] The same also applies to the cantonal income tax.[263] In this case, as well as on several other occasions, the Swiss Supreme Court referred to and applied the Circular No. 6. Nevertheless, it has never had to check its fundamental compatibility with the wording of the law.[264]

In another case, of 3 June, 2016, the Swiss Supreme Court had to determine whether a mortgage loan granted to a company willing to acquire buildings by an (independent) foundation but secured by a guarantee granted by a close relative to the shareholder of the company falls within the scope of the thin capitalisation rules.[265] The Court stated that it is necessary to determine to what extent the personal guarantee provided by the related person fulfils the economic function of equity.[266] It noted that this might be the case when the assets of the company (i.e. the value of the buildings amounting to CHF 17,825,570) only partly guarantee the loan (i.e. amounting to CHF 18,000,000).[267] In such case, one can presume that the part of the loan, which exceeds the amount, covered by the assets of the company (i.e. CHF 174,430) has been granted because of the personal guarantee provided by the person related to the shareholder.[268] Therefore, one needs to include this amount in the relevant debt capital from harmful lenders.[269]

5 Swiss Interest Limitation Rules after BEPS Action 4

After the Swiss interest limitation rules prior to BEPS Action 4 have been described in the previous chapter, this chapter will, as part of the task attributed by the Eucotax Wintercourse 2020, look at the implementation of BEPS Action 4 in Switzerland (section 5.2). A short overview of the interest limitation rule recommended by the OECD will firstly be provided (section 5.1).

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[260] BGer 30 September, 2015 (2C_560/2014), cons. 3.

[261] BGer 30 September, 2015 (2C_560/2014), cons. 3.3.5. The financial statements translated into the presentation currency are nevertheless the basis for determining taxable income and capital.

[262] BGer 30 September, 2015 (2C_560/2014), cons. 3.3.4.

[263] BGer 30 September, 2015 (2C_560/2014), cons. 4.

[264] BÖHI, verdecktes Eigenkapital, p. 216; HONGLER/BÖHI, p. 133. The Federal Court does not give opinion beyond the conclusions of the parties.

[265] BGE142 II 355. For a summary and a commentary, see DANON, p. 92 et seq.

[266] BGE142 II 355, cons. 7.3.

[267] BGE142 II 355, cons. 7.3.

[268] BGE142 II 355, cons. 7.3 and 7.4. Nevertheless, the proof that the actual financing is at arm's length remains reserved.

[269] In case of debt capital from independent third parties secured by shareholders, the qualification as hidden profit distribution should not trigger the tax consequences of thin capitalisation as stated in section 4.6 according to OESTERHELT, verdecktem Eigenkapital, p. 1008 and OESTERHELT, Aktionärsdarlehen, p. 186.

5.1 Overview of BEPS Action 4 – Recommended Approach

The 2015 Action 4 report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* recommended an approach based on a fixed ratio rule limiting an entity's net deductions for interest and payments economically equivalent to interest to a percentage between 10% and 30% of its EBITDA.[270] Interest payments above this threshold shall not be deductible for corporate income tax purposes, but no reclassification into dividends shall occur.[271] The goal of such a fixed ratio rule is to ensure that net interest deductions are linked to the taxable income generated by economic activities.[272] Therefore, the OECD/G20 proposes a broad definition of interest, including e.g. the finance cost element of finance lease payments or even certain foreign exchange gains.[273] The fixed ratio rule applies in principle both in relation with related parties and third parties.[274] As certain groups are highly leveraged for non-tax reasons, the approach can be supplemented by a worldwide group ratio rule, which allows an entity to exceed the fixed ratio in certain circumstances.[275] The suggested form of group ratio would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net third-party interest/EBITDA ratio of its worldwide group and would also apply an uplift of up to 10% to the group's net third party interest expense to prevent double taxation.[276]

The recommended approach allows countries to supplement the fixed ratio rule and group ratio rule with other provisions that reduce the impact of the rules when the risk of BEPS is lower. Such measures include: (i) a *de minimis* threshold that carves-out entities, which have a low level of net interest expense (ideally based on the net interest expense of the local group), (ii) an exclusion for interest paid to third party lenders on loans used to fund public-benefit projects, and (iii) the carry forward of disallowed interest expense and/or unused interest capacity for use in future years (whose aim is to address earnings volatility).[277] The report also recommends using targeted anti-avoidance rules.[278] The recommended approach should at least apply to all entities in multinational groups, although countries may apply it to entities in a domestic group (i.e. groups which operate wholly within a single country) and/or

[270] OECD/G20, 2016 Update, N 94 et seq. The report mentions factors, which countries should take into account in setting their fixed ratio, see OECD/G20, 2016 Update, N 99 et seq. Alternatively, EBIT can also be used as a benchmark.

[271] HONGLER/BÖHI, p. 138.

[272] See OECD/G20, 2016 Update, p. 14; BHOGAL, p. 36.

[273] OECD/G20, 2016 Update, N 36.

[274] OECD/G20, 2016 Update, N 50; DANON, p. 95 et seq.

[275] OECD/G20, 2016 Update, N 24 et seq. If a country does not introduce a group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.

[276] OECD/G20, 2016 Update, N 139 et seq. See HUBER/MAHAWATTAGE/BERR, p. 133 et seq.; HUBER/MAHAWATTAGE/BERR/MEYER-NANDI, p. 310.

[277] OECD/G20, 2016 Update, N 54 et seq., 64 et seq. and 159 et seq.

[278] OECD/G20, 2016 Update, N 171 et seq.

standalone entities.[279] It does not include a fixed debt-to-equity ratio or an arm's length test but acknowledges that these rules may still have a role to play within a country's tax system alongside the best practice approach.[280]

5.2 Implementation of BEPS Action 4 and the ATAD into Domestic Law

The OECD members, including Switzerland, have made a political commitment to implement certain minimum standards to fight BEPS.[281] In addition to the minimum standards, the final reports published by the OECD/G20 in October 2015 contained best practices and recommendations to the countries. The OECD/G20 has stated that BEPS Action 4 should be considered as a best practice to be implemented in domestic law.[282] In this context, the EU presented its proposal for an Anti-Tax Avoidance Directive (ATAD) in January 2016.[283] The proposal was adopted on 21 June, 2016 by the Council and entered into force on 8 August, 2016. It provides an interest limitation rule that is in line with the OECD/G20 recommended best practice.[284]

Switzerland has not committed to implementing BEPS Action 4. Therefore, it has not adopted and has not intended to adopt any change to the general principles governing the deductibility of interest payments.[285] It has not changed the definition of (deductible) interest or the general conditions governing the deductibility of interest. Nor has it introduced a fixed ratio rule or modified its domestic interest limitation provisions concerning financial undertakings. Because Switzerland is not part of the EU, it is also not forced to introduce any measure contained in the ATAD, especially article 4 ATAD.

6 Interaction of Domestic Interest Limitation Rules with other Tax Rules

After the Swiss interest limitation rules prior and after BEPS have been depicted above, this chapter focuses on the interaction of such rules with transfer pricing rules (section 6.1), other domestic rules preventing BEPS (section 6.2), other domestic (tax) law (section 6.3) and rules of double tax conventions (section 6.4).

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[279] OECD/G20, 2016 Update, N 44 et seq.; BURKHALTER-MARTINEZ, p. 56. However, the fixed ratio and the group ratio rules are unlikely to be effective for the banking and insurance industries, see OECD/G20, 2016 Update, N 29 and 183 et seq.

[280] OECD/G20, 2016 Update, N 15; BHOGAL, p. 37.

[281] OESTERHELT/SCHENK, p. 21. For example, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS ("MLI") entered into force on December 1, 2019 in Switzerland. See OECD/G20, MLI, p. 3.

[282] OECD/G20, BEPS Action 4 Final Report, p. 11.

[283] EUROPEAN COMMISSION, p. 1 et seq. See also GINEVRA, p. 120 et seq.

[284] BURKHALTER-MARTINEZ, p. 55.

[285] BÖHI/HONGLER, p. 687; HUBER/ISAENKO, p. 62.

6.1 Interaction with Transfer Pricing Rules (incl. art. 9 OECD-MC)

In order to determine appropriate transfer prices between related parties, international tax laws generally rely on the arm's length principle. Pursuant to this principle, the transactions entered into by related parties would be acceptable for tax purposes if unrelated parties under the same comparable facts and circumstances would also have entered into the same transactions.[286] The arm's length principle is specifically recognized in article 9(1) OECD-MC, according to which adjustments to profits can be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies or companies under common control) in different states on other than arm's length terms.[287] Since the determination of these transfer prices is a complex task, the OECD has published a report entitled "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", which represents internationally agreed principles and provides transfer pricing methods that should help in determining arm's length prices.[288]

The Swiss tax authorities require that transactions between related parties follow the arm's length principle.[289] However, there is currently neither legislation nor specific rules on the determination or adjustment of transfer prices.[290] The OECD Transfer Pricing Guidelines are generally accepted in Switzerland.[291] Some administrative instructions dealing with cross-border transfer pricing refer explicitly to the OECD Guidelines.[292] Nevertheless, there is no order of priority in the application of these rules in Switzerland and they are not blindly applied without taking the subjective considerations of each particular situation into consideration.[293]

With regard to thin capitalisation rules, the commentary on article 9(1) OECD-MC states that: "there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article [9(1)]".[294] According to the OECD, article 9 OECD-MC does not prevent the application of national rules on thin capitalisation insofar (and only insofar) as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits,

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[286] MARTINHO FERNANDES, p. 26; FROSS, p. 508. If so, the related parties are deemed to have dealt at arm's length.

[287] OECD-MC, Commentary 2017, art. 9 N 1. In case of economic double taxation, the residence state of the lender shall make a corresponding adjustment according to art. 9(2) OECD-MC. When such adjustment is not possible, the competent authorities will seek solutions within the framework of mutual agreement procedures (art. 25 OECD-MC). Regarding the arm's length principle, see also art. 7(2) OECD-MC.

[288] See OECD/G20, Transfer Pricing Guidelines, p. 1 et seq. The report has initially been approved by the Council of the OECD on 27 June, 1995. It is periodically updated. See also OECD-MC, Commentary 2017, art. 9 N 1.

[289] See e.g. SFTA-Circular 4, p. 1.

[290] See BÖHI, verdecktes Eigenkapital, p. 100; OBERSON/HULL, p. 242.

[291] OECD/G20, Transfer Pricing Country Profile, p. 1; DEJARDIN, p. 146 et seq.; OBERSON/HULL, p. 243.

[292] See SFTA-Circular 4, p. 1.

[293] OBERSON/HULL, p. 243.

[294] OECD-MC, Commentary 2017, art. 9 N 3.

which would have accrued in an arm's length situation.[295] Further, article 9 is not only relevant in adjusting the rate of interest provided for in a loan contract, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.[296] According to the literature, questions arise especially regarding the reconciliation of fixed ratio approach and earnings stripping rules with article 9(1) OECD-MC because of the inflexible nature of these rules.[297]

In Switzerland, the thin capitalisation rules follow a safe harbour approach and are asset-based, i.e. for each type of asset, only a specific percentage may be financed with debt.[298] The relationship with transfer pricing rules is quite straightforward as the arm's length test is an integral part of the thin capitalisation rules.[299] The taxpayer (borrower) has any time the possibility to prove that the specific financing is at arm's length.[300] This is explicitly stated in the Circular No. 6 relating to the maximum (deductible) interest capacity and the safe haven interest rates (for loans in Swiss francs and foreign currency) published annually by the SFTA.[301] Although the wording of the law does not mention the arm's length principle, the Swiss Supreme Court confirmed its application concerning the thin capitalisation rules.[302] Therefore, the Swiss thin capitalisation rules are in accordance with the transfer pricing rules.[303] In other words, interest payments in line with the arm's length principle will always be deductible and will never be reclassified as dividends in Switzerland.

6.2 Interaction with other Domestic Rules preventing BEPS

Switzerland has no specific anti-avoidance tax act in order to prevent BEPS. However, the Swiss Federal Supreme Court has developed a general anti-abuse rule (GAAR) as a judicial practice back since the 1930s.[304] Based on the general principle of abuse of law, tax authorities have the right to tax a legal structure based on its economic substance when (i) the structure is unusual or at least unsuitable for the economic purpose pursued, (ii) the choice of the structure was made solely to save taxes and (iii) the structure would effectively lead to a

[295] OECD-MC, Commentary 2017, art. 9 N 3. However, the application of thin capitalisation rules should not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit. See also section 7.2.3.

[296] OECD-MC, Commentary 2017, art. 9 N 3.

[297] These kinds of thin capitalisation rules generally ignore the nature of transactions in ensuring that the specified ratio is respected. See section 7.2.3; ASIMAKOPOULOS, p. 408 et seq.; FROSS, p. 507 et seq.; BOHN, p. 47.

[298] FROSS, p. 508 et seq. See section 4.3.

[299] See section 4.5. The arm's length principle according to article 9(1) OECD-MC and according to the Swiss thin capitalisation rules is basically the same.

[300] Finally, the actual interest expense should not exceed the maximum interest capacity, see section 4.5.

[301] SFTA-Circular 6, p. 2; SFTA-Circular Letter CHF, p. 2 and SFTA-Circular Letter FCY, p. 2.

[302] BGer 6 November, 2008 (2C_259/2008), cons. 2.4.1.

[303] See BAMMENS, p. 149 et seq.; BURKHALTER-MARTINEZ, p. 59 et seq.

[304] MATTEOTTI, p. 101 et seq.; KUNZ-SCHENK, p. 764 et seq.; BGE 138 II 239, cons. 4; HONGLER/WINZAP, p. 839 et seq.; CORNU, p. 1 et seq.

significant tax saving if the tax authorities would accept it.[305] As a further rule preventing BEPS in the field of hybrid instruments, Switzerland has a longstanding experience in denying its participation relief[306] where the payment is treated as a deductible expense at the level of the paying subsidiary.[307] This rule represents an equivalent of the defensive rule proposed by the BEPS report.[308] No recommendations of the OECD relating to Action 2 BEPS have therefore been adopted in Switzerland.[309] Nor has Switzerland introduced or planned to introduce any CFC rules according to Action 3 BEPS.[310] The reason is that Switzerland's jurisdiction to tax, although applying on a worldwide basis, is limited by the principle of territoriality in several areas.[311] Moreover, an unilateral tax exemption is provided for income attributable to foreign enterprises, permanent establishments or real estate.[312]

In relation with the Swiss thin capitalisation rules, the domestic GAAR mentioned above is applicable anytime assumed its conditions are fulfiled. Both sets of rules follow the same purpose, as the thin capitalisation rules aim to prevent abusive debt financing.[313] Assuming the financing of a taxpayer is satisfying the safe harbour rules of the SFTA, it could, in principle, still be subject to review under the GAAR. The rule to deny participation relief if a payment is deductible for the company conducting it according to article 70(2)(b) FDTA is applied simultaneously with the thin capitalisation rules.[314] Indeed, the interest expense on deemed equity that is reclassified as non-deductible is no more subject to article 70(2)(b) FDTA and can be considered as earnings on participations qualifying for participation relief according to articles 70 FDTA as well as 28(1) and 28(1bis) FTHA.[315]

6.3 Interaction with other Rules of Domestic Law

According to articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA, the taxable profits of corporations and cooperatives shall also include the interest owed on the portion of borrowed funds which *economically correspond* to equity capital. As outlined above, the wording of the

[305] See BGE 131 II 627, cons. 5.2; BGer 22 October, 2003 (2A.470/2002 and 2A.473/2002), cons. 4.1.

[306] See section 2.3.3 *in fine*.

[307] See art. 70(2)(b) FDTA. See also DANON/SCHELLING, p. 199.

[308] HUBER/ISAENKO, p. 62.

[309] However, the recommendations provided by the OECD in relation to Action 2 are much wider than the actual art. 70(2)(b) FDTA.

[310] FROSS/REESE, p. 46. See also the recent case law that provides foundations for taxing passive income with an insufficient nexus to a foreign country in: DANON/SCHELLING, p. 202.

[311] DANON/SCHELLING, p. 201. Therefore, Swiss residents are not taxed on the earnings derived from foreign legal entities until these earnings are effectively distributed. Another reason is that tax treaties concluded by Switzerland favour the exemption method according to art. 23A OECD-MC.

[312] See section 2.3.3.

[313] BÖHI, verdecktes Eigenkapital, p. 100.

[314] According to BHOGAL, p. 37, any restrictions under hybrid mismatch arrangements (Action 2) should apply in priority to Action 4.

[315] SFTA-Circular 27, 2.4.1, p. 4; HONGLER, Finanzierungsinstrumente, p. 107. See also section 4.6. The GAAR could also be used to scrutinise hybrid mismatch arrangements, see HUBER/ISAENKO, p. 62.

law clearly aims at an economic approach (*substance over form* approach).[316] The debt under scrutiny needs to have the relevant economic functions of equity as defined in section 3.1.1, namely the continuity and existence, loss compensation, liability and profit participation functions, in order to justify reclassification.[317] More precisely, and in accordance with the literature, a reclassification as deemed equity should only be possible if (i) no relevant economic features of debt are left and (ii) the business risk of the creditor is equal to the business risk of the equity investor.[318] It is irrelevant whether the company is undercapitalised; only the quality of the financing is relevant.[319]

As shown above, the actual practice of the Swiss tax administration, laid down in Circular No. 6, is based on asset/debt ratios per asset category and follows, therefore, in principle, a *form over substance* approach.[320] It is based on the capitalisation of the company and makes basically no reference to the economic significance of the debt.[321] The subordination of the debt or its repayment period and conditions are not taken into account, although these elements are crucial to determine the quality of the debt. The arm's length test, which is not directly addressed in the wording of the law, indirectly and partially corrects this by allowing an individual assessment of the debt.[322] Nonetheless, the arm's length test relates to the interest rates at which borrowed capital would be available from independent third parties and does not address the economic qualification as debt or equity. One can assume that, as long as the interest rate is sufficiently high, an independent party can be found in order to provide debt capital. Further, the arm's length test reverses the burden of proof as it let the taxpayer find evidence of the conformity of its financing.[323] However, whether debt effectively constitutes economic equity would have to be proven by the tax authorities due to the tax-increasing consequences for the taxpayer.[324]

It follows from the above that the approach of Circular No. 6 is not compatible with the legal concept of articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA that clearly refers to the economic significance of the debt. Swiss legal literature has relatively broadly identified this

[316] See section 4.2.

[317] See HONGLER, Finanzierungsinstrumente, p. 61. The literature is of the opinion that votings right (control function) are not necessary for reclassification as deemed equity, see BÖHI, verdecktes Eigenkapital, p. 162.

[318] BÖHI/HONGLER, p. 684; BÖHI, verdecktes Eigenkapital, p. 283. Regarding the debt features, see section 3.1.2.

[319] HONGLER, Finanzierungsinstrumente, p. 58

[320] BÖHI, verdecktes Eigenkapital, p. 216. A reason for this might be that in the run-up to the publication of Circular No. 6 in 1997, the SFTA consulted *inter alia* the Swiss banking practice, which was much more oriented towards assets in the 1980s and 1990s and less towards cash flow than today.

[321] HONGLER, Finanzierungsinstrumente, p. 63.

[322] HONGLER, Finanzierungsinstrumente, p. 59.

[323] BÖHI, verdecktes Eigenkapital, p. 217.

[324] HONGLER, Finanzierungsinstrumente, p. 64.

problem.[325] Although the Circular No. 6 serves the principle of legal certainty, providing the taxpayers with the insurance that their debts will not be reclassified into deemed equity if they meet the outlined requirements, it does not comply with the wording of the law.[326] Indeed, it does not consider the quality or functions of the financing as such but focuses solely on the relationship between assets and liabilities. For example, according to an economic analysis, instruments for strengthening the capital base of banks like CoCo-Bonds or Write-Off-Bonds should be added to the hidden capital as these financing instruments have the same or similar functions as equity.[327] According to the practice of the SFTA, however, a reclassification could only occur if the investor would be a shareholder, the debt would exceed the relevant asset/debt ratio and the arm's length test would fail. Reciprocally, the Circular No. 6 could also lead to distorted results in that a lender qualifies as an equity investor for tax purposes even though it has not functionally contributed equity capital and is not exposed to the corresponding business risk. Circular No. 6, whilst using percentage thresholds, also takes too little account of differences between companies or sectors, which would be required by an economic analysis.[328]

According to HONGLER/BÖHI[329], while the Circular No. 6 is typically a thin capitalisation rule (*Unterkapitalisierungsvorschrift*) which does not require a functional analysis of the quality of a financing but focuses (pragmatically) on the maximum debt allowed to be provided by related parties, articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA should be considered as provisions on deemed equity (*Bestimmung zum verdeckten Eigenkapital*), whose main point is to analyse whether a financing corresponds functionally more to equity or debt. Historically, the goal of the provisions on hidden capital was to prevent tax avoidance by examining whether debt financing has the economic significance of equity capital.[330] Indirectly, these rules also limit prohibitive debt financing and interest. It would, however, be inappropriate to interpret the law in a way that goes beyond its wording to argue that it should be understood as a pure thin capitalisation rule.[331] Circular No. 6 does not have the character of law in its strictest sense; it is rather an administrative regulation, which is in principle binding for the

[325] BÖHI, verdecktes Eigenkapital, p. 216; VON SALIS-LÜTOLF, p. 174 et seq.; ROBINSON/WIPFLI, p. 75; SCHMID, IFA 1996, p. 730 et seq.; HÖHN/WALDBURGER, Band I, § 19 N 12.

[326] BÖHI, verdecktes Eigenkapital, p. 217.

[327] HONGLER/BÖHI, p. 132. For a definition of CoCo-Bonds and Write-Off-Bonds, see HONGLER, Finanzierungsinstrumente, p. 30 et seq. For example, CoCo-Bonds allow investors to participate in profits from the time of issue (profit participation function). The investors bear a high risk even before conversion, as they make their money available for an unlimited period of time and cannot withdraw it (continuity function). The investors also bear the negative consequences of the company's development (loss compensation function).

[328] HONGLER/BÖHI, p. 132.

[329] HONGLER/BÖHI, p. 132. For example, a higher earnings expectation may actually justify a lower equity base compared to a company in the same industry.

[330] See section 4.2.2 above.

[331] HONGLER/BÖHI, p. 133.

assessment authorities, but never for the courts.[332] It would, therefore, be very interesting to see how the Swiss Supreme Court would rule this question if it had to do so.[333] Moreover, *de lege ferenda*, either the Circular No. 6 should be brought into line with the wording of the law (art. 65 FDTA, 24(1)(c) and 29*a* FTHA) or an adjustment of the latter should be evaluated.[334]
Regarding the relation of the thin capitalisation rules with the general constitutional principles of taxation[335], the fact that non-deductible interest expense on deemed equity is added back to the taxable net profit of the borrower is in line with the ability-to-pay principle to the extent that it ensures "horizontal tax justice"[336] on the one hand and implements the total profit principle on the other.[337] The reclassification of deemed equity as taxable equity for capital tax purposes also complies with the ability-to-pay principle as long as it can compensate an adverse balance and is not considered equivalent to the paid-up share capital.[338] This rule now applies for every canton as per the ruling of the Swiss Supreme Court in November 2008.[339] The thin capitalisation rules are also compliant with the principle of non-discrimination and the principle of legality.[340]

6.4 Interaction with Rules of Double Tax Conventions

The following section examines the treatment of the Swiss interest limitation rules under tax treaty law. The interaction of the Swiss interest limitation rules with articles 10(3) and 11(3) OECD-MC, article 11(6) OECD-MC and with the non-discrimination provision of article 24 OECD-MC will be analysed. It should be noted that the following comments, based on the OECD-MC, are general. In individual cases, an interpretation of the specific double taxation agreement is required.

6.4.1 Relation to Articles 10(3) and 11(3) OECD-MC

The first question that arises is whether the reclassified non-deductible interest expense, which is treated as dividends under Swiss domestic law, shall qualify as dividend (art. 10 OECD-MC) or interest (art. 11 OECD-MC) for tax treaty purposes. According to article 10(3) OECD-MC, the term *dividend* means income from shares, *jouissance* shares or *jouissance* rights, mining shares, founders' shares or other rights, not being debt-claims, participating in

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[332] BÖHI, Übersicht, p. 180.
[333] In BGer 30 September, 2015 (2C_560/2014), cons. 3.3.4, the Swiss Supreme Court stated that whether deemed equity and interest on equity are to be assumed must be assessed exclusively according to the rules and logic of business administration (*Regeln und Logik der Betriebswirtschaftlehre*). However, the Swiss Supreme Court applied the SFTA-Circular 6, p. 1 without verification of its conformity with the law. For a comment, see HONGLER/BÖHI, p. 135 et seq.
[334] BÖHI/HONGLER, p. 684 et seq.; BÖHI, Übersicht, p. 180.
[335] See section 2.2.
[336] See section 2.2.
[337] BÖHI, verdecktes Eigenkapital, p. 179. Regarding the total profit principle, see section 2.3.3.
[338] BÖHI, verdecktes Eigenkapital, p. 179 et seq.
[339] BGer 6 November, 2008 (2C_259/2008), cons. 2.5.3.
[340] BÖHI, verdecktes Eigenkapital, p. 182 et seq. Regarding the principle of legality, see section 2.2.

profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.[341] In contrast, according to article 11(3) OECD-MC, the term *interest* refers to income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Further, according to the commentary, the term *interest* as used in article 11 OECD-MC does not include items of income, which are dealt with under article 10 OECD-MC.[342]

Neither article 10 nor article 11 of the OECD-MC contains any explicit comments on the treatment of interests on deemed equity. The commentary states that article 10 OECD-MC deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when repayment depends largely on the success or otherwise of the enterprise's business.[343] According to the commentary, "articles 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitalisation applied in the borrower's country".[344] In international tax theory, there is also little agreement on the treaty law treatment of interest on deemed equity, mainly because of the different approach in the individual countries.[345]

Part of the literature[346], as well as the OECD Thin Capitalization Report of 1986[347], seem to follow the view that the interests on deemed equity capital should be treated as dividends under article 10(3) OECD-MC because these interests are considered equivalent to dividends for domestic tax purposes. Another reason for treatment as dividends is that the interest payment and the underlying debt financing lie in the investor's position as a shareholder (or as a related person) of the borrower.[348] It is also the practice in Switzerland that such excessive interests, which qualify as constructive dividends for domestic corporate

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[341] The special wording of the DTA might deviate from the OECD-MC, see for example art. 10(4) DTA CH-D and art. 10(4) DTA CH-USA.

[342] OECD-MC, Commentary 2017, art. 11 N 19.

[343] OECD-MC, Commentary 2017, art. 10 N 25. The contributor of the loan is presumed to share the risks run by the enterprise when (i) the loan very heavily outweighs any other contribution to the enterprise's capital or is substantially unmatched by redeemable assets, (ii) the creditor will share in any profits of the company, (iii) repayment of the loan is subordinated to claims of other creditors or to the payment of dividends, (iv) the level or payment of interest would depend on the profits of the company or (v) the loan contract contains no fixed provisions for repayment by a definite date.

[344] OECD-MC, Commentary 2017, art. 10 N 25.

[345] HONGLER, Finanzierungsinstrumente, p. 302.

[346] MEISTER, p. 125 et seq.; TISCHBIREK/SPECKER, art. 10 N 200 OECD-MC.

[347] See OECD, Thin Capitalization Report 1986, N 56: "[t]he majority of the Committee felt that it would be appropriate in certain cases to regard as a dividend a payment which had been treated as a dividend under national rules dealing with thin or hidden capitalization". A dividend qualification is assumed on condition that the investor effectively bears the entrepreneurial risk, see OECD, Thin Capitalization Report 1986, N 57.

[348] See HELMINEN, p. 338. This argument requires, however, that the provision on deemed equity is only applied to related party financing and not to third-party financing, which is the case in Switzerland.

income and withholding tax purposes, are also qualified as dividends for treaty purposes.[349] Article 10 OECD-MC would therefore apply. As a consequence, in case of classification of payments as dividends for treaty purposes, a full refund of Swiss withholding taxes is only possible if the lender is the parent company of the borrower and if the treaty contains a 0% rate in the dividend articles for intragroup situations.[350]

Other scholars deny the subsumption under the dividend article since the domestic tax reclassification in deemed equity does not necessarily have to result in the same reclassification under tax treaty law.[351] Further, according to the wording of article 10(3) OECD-MC, only a qualification as "income from other corporate rights which is subjected to the same taxation treatment as income from shares" by the state of residence of the borrower could potentially comes into consideration since deemed equity is not a "share" and is by definition "debt-claim".[352] However, such qualification is only possible if a "corporate right" exists and, as outlined above, deemed equity does not fulfil this condition.[353] According to HONGLER, it is also incorrect to consider that interest on deemed equity is not directly but indirectly attributable to the position of the investor as a shareholder of the borrower as such interpretation does not result from the wording of article 10(3) OECD-MC.[354] Therefore, in accordance with that part of the literature, the interest on deemed equity should still be considered as interest in the sense of article 11(3) OECD-MC. Provided that the payments are classified as interests for treaty purposes, such interests will generally be subject to no withholding tax or at least to a lower withholding tax than dividend distributions.[355]

In the author's view, the latter position seems more convincing. Indeed, the reclassification as dividend occurs only for tax purposes and not under commercial (civil) law.[356] Subject to the specific conditions agreed upon, the deemed equity capital is and remains capital made available to a company for a certain period of time without priority satisfaction in the event of liquidation and participation in the profit of the borrower. Based on the wording of the OECD-MC, interest on deemed equity should be qualified as interest according to article 11(3) OECD-MC. However, this is subject to different agreements in the specific DTAs, which

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[349] HONGLER/BÖHI, p. 688; HONGLER, Finanzierungsinstrumente, p. 303. BSK OECD-MC-OESTERHELT/HEUBERGER, art. 10 N 266b. Switzerland generally follows the direct attribution rule, i.e. the withholding tax must be paid by the person who has benefited from the payment in a manner recognisable to third parties. This person must also fulfil the conditions for repayment of the withholding tax.

[350] HONGLER/BÖHI, p. 688. This means that a full refund for sister companies is not possible. See section 3.3.1 for the consequences of the qualification as dividends for treaty purposes.

[351] HONGLER, Finanzierungsinstrumente, p. 305 et seq. and the references mentioned.

[352] HONGLER, Finanzierungsinstrumente, p. 305 et seq.

[353] HONGLER, Finanzierungsinstrumente, p. 306. The other condition, namely that the interest on deemed equity is treated as shares for tax purposes, is met in Switzerland, see section 4.6.

[354] HONGLER, Finanzierungsinstrumente, p. 305 et seq.

[355] See section 3.2.2 for the consequences of the qualification as interest for treaty purposes.

[356] See section 4.6.

could explicitly provide for allocation to article 10 OECD-MC by removing the condition of a "corporate right".[357] It is also imaginable that a DTA explicitly specifies that interest on deemed equity capital shall qualify as dividend under tax treaty law.

6.4.2 Relation to Article 11(6) OECD-MC

According to article 11(6) OECD-MC, where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of article 11 OECD-MC shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each contracting State, due regard being had to the other provisions of the convention. According to the commentary, article 11(6) OECD-MC permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan as to give it the character of a contribution to equity capital.[358]

The question that arises in this context is whether the interests on deemed equity are a case of application of article 11(6) OECD-MC. According to the literature, articles 65 FDTA, 24(1)(c) and 29*a* FTHA regulate other situations than those covered by article 11(6) OECD-MC.[359] The Swiss interest limitation rules do not have primarily the amount of the interest rate as an object, but rather the quality of the financing itself.[360] Moreover, unlike article 11(6) OECD-MC, the tax administrations also review excessively low-interest payments.[361] Therefore, article 11(6) OECD-MC is of no relevance in connection with the treatment of interests on deemed equity under treaty law.[362] However, according to the commentary, the recognition of interests on deemed equity could be carried out following article 11(6) OECD-MC if the wording of the DTA would be adapted.[363]

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[357] See, for example, the protocol of the DTA between Switzerland and the Netherlands, art. X to art. 10(6), 11(3) and 13: "Notwithstanding the provisions of paragraph 6 of Article 10, paragraph 3 of Article 11 and Article 13, it is understood that payments on a loan, including payments on value changes of the loan, shall be treated as a dividend insofar as these payments are treated as a distribution by the tax laws of the Contracting State of which the company making the payments is a resident".

[358] OECD-MC, Commentary 2017, art. 11 N 35; MARRES, p. 51.

[359] HONGLER, Finanzierungsinstrumente, p. 301 et seq. See also PÖLLATH/LOHBECK, art. 11 N 118 et seq. OECD-MC.

[360] HONGLER, Finanzierungsinstrumente, p. 302. See section 4.2. The safe haven approach adopted by the SFTA does not correspond to such interpretation of the law, see section 6.3.

[361] HONGLER, Finanzierungsinstrumente, p. 302.

[362] HONGLER, Finanzierungsinstrumente, p. 302. See also THOEMMES/NAKHAI, p. 132.

[363] OECD-MC, Commentary 2017, art. 11 N 35. For example, by removing the limiting phrase "having regard to the debt-claim for which it is paid".

6.4.3 Relation to Articles 24(4) and 24(5) OECD-MC

The main goal of tax treaties is to allocate taxing rights between contracting states in order to avoid double taxation. However, tax treaties also prevent the application of discriminatory tax treatment.[364] Domestic interest limitation rules must, therefore, meet the requirements of the discrimination provision of article 24 OECD-MC or the corresponding provisions in the agreements concluded by Switzerland. In particular, paragraphs 4 and 5 of the article 24 OECD-MC are relevant in the context of interest limitation rules.[365]

According to article 24(4) OECD-MC, interest payments paid to a lender residing in another state must be deductible under the same conditions as if they had been paid to a resident of the same state of the borrower.[366] Thus, any discrimination based on the residence of the interest recipient is prohibited.[367] As a preliminary remark, one needs to emphasise that the fact that an interest payment is recharacterised as a constructive dividend for domestic tax law purpose should not allow a state to elude the application of article 24(4) OECD-MC. Indeed such interest payment should still be considered as an "other disbursement" within the meaning of article 24(4) OECD-MC.[368] Further, according to the OECD, article 24(4) OECD-MC does not prohibit the country of the borrower from applying its thin capitalisation rules insofar as they are compatible with the arm's length principle set out in articles 9(1) and 11(6) OECD-MC.[369] A reclassification of interests into constructive dividends is therefore not prevented by article 24(4) OECD-MC, provided that the adjustment is based on a violation of the arm's length principle.[370] However, if such treatment results from rules, which are not compatible with the arm's length principle and which only apply to non-resident lenders (to the exclusion of resident lenders), then such treatment is prohibited by article 24(4) OECD-MC.[371]

Article 24(5) OECD-MC states that domestic enterprises held wholly or partly, directly or indirectly, by foreign persons may not be subject to a less favourable tax treatment than domestic enterprises with domestic shareholders.[372] This provision, and the discrimination which it puts an end to, relates only to the taxation of enterprises and not of the persons

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[364] BURKHALTER-MARTINEZ, p. 57.

[365] See ELLIFFE, p. 9.

[366] This principle also applies for capital taxation purposes.

[367] RUST, art. 24 N 145 OECD-MC.

[368] See BAMMENS, p. 150 et seq., according to which interpreting the term *interest* based on domestic law pursuant to art. 3(2) OECD-MC (with the result that interests targeted by domestic thin capitalisation rules are not considered as interests) does not respect the principle of good faith of art. 31 VCLT.

[369] OECD-MC, Commentary 2017, art. 24 N 74; ELLIFFE, p. 10.

[370] HONGLER/BÖHI, p. 145; BSK OECD-MC-OESTERHELT, art. 24 N 136; RUST, art. 24 N 147 OECD-MC; Regarding the relation between the domestic interest limitation rules and the transfer pricing rules, see section 6.1.

[371] OECD-MC, Commentary 2017, art. 24 N 74. According to HONGLER/BÖHI, p. 145, this applies regardless of whether or not the domestic interest limitation rule complies with art. 9(1) OECD-MA.

[372] RUST, art. 24 N 160 OECD-MC. See also BGer 6 January, 2004 (2A.542/2002), cons. 3.4.3.

owning or controlling their capital.[373] Its object, therefore, is to ensure equal treatment for taxpayers residing in the same state, and not to subject foreign capital to the same treatment as domestic capital.[374] It follows that generally, if an interest limitation rule violates article 24(5) OECD-MC, it is also in breach of article 24(4) OECD-MC.[375]

If a domestic interest limitation rule does not relate to the residence of the interest recipients or of the shareholders of the borrower and provides that reclassification is made under the same conditions for domestic and foreign persons, then such a rule is not discriminatory in the sense of article 24(4) and 24(5) OECD-MC.[376] This is the case in Switzerland as the thin capitalisation rules do not treat domestic and foreign interest recipients differently.[377] Therefore, the Swiss interest limitation rules are in line with article 24(4) and 24(5) OECD-MC.[378] The situation would be different if the scope of the interest limitation rules would be limited to interest payments to foreign related companies and the taxpayer would not have the possibility to prove that the financing is at arm's length.[379]

7 Fiscal Policy Options

7.1 Preliminary Remarks and Fiscal Policy Objectives[380]

As stated in section 6.3, the administrative practice of the SFTA set out in Circular No. 6 does not comply with the wording of articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA, which refer to the economic significance of the debt. This section intends to discuss various fiscal policy options that would allow to eliminate such inconsistency between the law and the practice of the SFTA.

As a prerequisite, any amendment to the existing provisions or new regulation on interest limitation must be in line with the constitutional rules, especially article 127 FC[381], and the

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[373] OECD-MC, Commentary 2017, art. 24 N 76; ELLIFFE, p. 13.

[374] OECD-MC, Commentary 2017, art. 24 N 76 et seq. For example, if under a state's domestic thin capitalisation rules, a resident enterprise is not allowed to deduct interest paid to an associated non-resident enterprise, that rule would not be in violation of art. 24(5) OECD-MC, provided that the treatment would be the same if the interest had been paid to an associated non-resident enterprise that did not itself own or control any of the capital of the payer. However, such a domestic rule could violate para. 4 to the extent that different conditions would apply for the deduction of interest paid to residents and non-residents, and assuming that the domestic rule is incompatible with articles 9(1) and 11(6) OECD-MC.

[375] BAMMENS, p. 163 et seq.

[376] HONGLER/BÖHI, p. 146; BURKHALTER-MARTINEZ, p. 62.

[377] See section 4.2.2.

[378] HONGLER/BÖHI, p. 146; HONGLER, Finanzierungsinstrumente, p. 300 et seq.; BSK OECD-MC-OESTERHELT, art. 24 N 136. ELLIFFE, p. 40 states that domestic thin capitalisation rules, which are consistent with the arm's-length principles in articles 9(1), 11(6) and 12(4) OECD-MC, override article 24(5) OECD-MC.

[379] Regarding the relationship between articles 9(1) and 24(4) OECD-MC, see BURKHALTER-MARTINEZ, p. 60.

[380] The following chapter focuses on the amendment of the Swiss thin capitalisation rules from a domestic point of view. In a cross-border context, other objectives might be pursued, e.g. the avoidance of double taxation or double non-taxation. See CENCERRADO/SOLER ROCH, p. 59.

international treaties, including double tax conventions.[382] Such rules are the legal framework within which the tax legislator can act. Regarding the fiscal policy objectives, any adjustment of the administrative practice and/or of the wording of the law must prevent effectively abusive debt financing, i.e. the taxpayers should not have the possibility to evade such measures.[383] In the author's view, as well as according to a large part of the literature[384], the protection of the domestic tax substrate should not be recognised as a legitimate objective, due to the restriction of the freedom of financing.[385] Further, any adjustment must support the international acceptance of the Swiss corporate tax system, which was one of the three goals of the Corporate Tax Reform III accepted by the people of Switzerland on 19 May, 2019.[386] Moreover, the OECD/G20 emphasises that the possible adjustments should not lead to unnecessary legal uncertainty.[387] Because of the international tax competition, the effect of such adjustments on the attractiveness of Switzerland should also be considered.[388]

This being stated, this chapter will examine in more details four fiscal policy options, which seem the most relevant for Switzerland. Option 1 is the introduction of the OECD/G20 recommended approach as introduced under section 5.1 (section 7.2). Option 2 analyses the implementation of the economic distinction between equity and debt in a way complying with the legal *substance over form* approach (section 7.3). Option 3 proposes to adapt the law to the actual practice of the SFTA with a genuine legal provision (section 7.4). Finally, option 4 envisages to abolishing existing thin capitalisation rules (section 7.5). The following statements are hypothetical and do not claim to be exhaustive.

7.2 Option 1: Introduction of the OECD/G20 Recommended Approach

7.2.1 Comparison with the Swiss Interest Limitation Rules

In order to recognise which changes would be associated with a possible introduction of the recommended approach of the OECD/G20 in Switzerland, the following chart presents and summarises the main features of the existing Swiss interest limitation rules and the OECD/G20 approach[389]:

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[381] See section 2.2.

[382] For the interaction of the existing rules with rules of double tax conventions, constitutional principles and other domestic tax rules, see chapter 6.

[383] This includes the objective that interest deductions remain linked to the taxable income generated by economic activities, see section 5.1. Regarding the difference between illegal, abusive and unjustified financing, see BOHN, p. 102.

[384] BOHN, p. 101.

[385] HONGLER/BÖHI, p. 139. However, the OECD/G20's Action 4 clearly aims at preventing BEPS through debt financing, see section 5.1. Regarding the freedom of financing, see MÜLLER, p. 6 et seq.

[386] See section 2.4.

[387] OECD/G20, Explanatory Statement, N 25.

[388] Generally, other location factors such as the qualification of the workforce or the quality of the infrastructure can only be influenced in the long term by the legislator, while the tax policies are much more flexible and can show results in the short term.

[389] For more details, see chapter 4 and section 5.1.

	OECD/G20 Recommended Approach	Swiss Interest Limitation Rules
Basic concept	Fixed ratio rule based on earnings	Differentiated asset/debt ratios
Measure of permissible interest expense	EBITDA or EBIT based on (tax) income statement	Market value of assets at the end of tax period
Scope of application	All interest payments or payments economically equivalent to interest (broad definition)	Limitation of interest payments to shareholders or persons related to them
Personal scope	At least all entities in multinational groups. Also possible: entities in a domestic group and/or standalone entities	Companies and cooperatives subject to unlimited taxation in Switzerland[390]
Intertemporality	Disallowed interest expense and/or unused interest capacity can be carried forward and carried back	N/A
Industry differentiation	Special rules for banks and insurance companies	Special rules for banks and insurance companies
Exceptions	Group ratio rule; *de minimis* threshold; public-benefit projects	Arm's length test (taxpayer can prove financing is at arm's length)
Legal consequences	Interests not deductible for corporate income tax purposes	Debt reclassified as deemed equity for capital tax purposes; interest reclassified as constructive dividend for income and withholding tax purposes

Table 6: OECD/G20 Recommended Approach vs. Swiss Interest Limitation Rules[391]

7.2.2 Conformity with Swiss Constitutional Principles

As stated above, any amendment to the existing provisions or new regulation must comply with the principles of the federal Constitution.[392] In this context, the conformity of the OECD/G20 recommended approach with the ability-to-pay principle[393] seems particularly problematical.[394] Indeed, considerable debate exists in Germany on the question of whether the German thin capitalisation rules, which are similar to the BEPS/G20 recommended

[390] See section 4.4 for more details.

[391] Own representation, based on BOHN, p. 158 et seq.

[392] For more details about the constitutional principles relevant for taxation, see section 2.2.

[393] According to this principle, every taxpayer must contribute to the financial needs of the community in proportion to the resources available to him ("vertical tax justice") and persons or groups of persons with the same income should pay the same amount of tax ("horizontal tax justice"). See art. 127(2) FC and fn. 30.

[394] The conformity of the recommended approach with the other principles of art. 127 FC, i.e. the principles of legality, universality of taxation and uniformity of taxation seems less problematical. However, in case the rule would state that the interest expenses shall be calculated according to a private accounting standard (e.g. IFRS financial statements), it is unsure whether the principle of legality would be satisfied, see HONGLER/BÖHI, p. 151.

approach[395], comply with the objective principle of net income taxation (*Nettoprinzip*).[396] Such principle, which is derived from the constitutional rule of equality and is a sub-principle of the ability-to-pay principle, states that taxpayer may deduct expenses incurred in order to generate income.[397] According to the literature, the principle of net income taxation relates to the Swiss ability-to-pay principle.[398] The German considerations on this issue are therefore also relevant for the situation in Switzerland.

In 2015, the German Federal Tax Court came to the conclusion that the German thin capitalisation rules were not compatible with the ability-to-pay principle.[399] It asked the German Federal Constitutional Court to rule on this issue, whereas the ruling of the latter court is still pending.[400] The main problem is that operating interest expenses, which are justified on business grounds, may qualify as non-deductible due to the thin capitalisation rules and therefore no taxation of the net income may occur.[401] The German Federal Tax Court also concluded that the fact that non-deductible interest could be carried forward or carried back in other tax periods, as provided by the German thin capitalisation rules, does not influence the (non-)conformity of the rules with the objective principle of net income taxation.[402] The German court justified its opinion by putting forward that it is generally uncertain whether the non-deductible interest could ever be carried forward as this depends on the ability of the taxpayer to generate income (respectively EBITDA) exceeding the interest expenses incurred.[403] The German literature proposes, *inter alia*, two justifications for possible violation of the objective principle of net income taxation. On the one hand, such a violation could be justified because the thin capitalisation rules could prevent the tax substrate's relocation.[404] On the other hand, it is argued that the thin capitalisation rules are justified because there is a qualified fiscal purpose (*qualifizierter Fiskalzweck*), meaning that such rules are justified because they dampen economic fluctuations and thus stabilise tax revenues.[405] The German Federal Tax Court dismissed both arguments by stating that the thin capitalisation rules have further purposes than just protecting the domestic tax substrate[406] and that no qualified fiscal purpose exists in this context.[407]

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[395] DELOITTE, p. 1.

[396] HEUERMANN, p. 1 et seq.; MÜNCHEN/MÜCKL, p. 1469 et seq.; KNÖLLER, p. 329. Concerning the conformity of the BEPS/G20 recommended approach with the EU-law, see VAN OS, p. 184 et seq.

[397] See MÜNCHEN/MÜCKL, p. 1470; KNÖLLER, p. 329.

[398] HONGLER/BÖHI, p. 140; MATTEOTTI, p. 24 et seq.

[399] Bundesfinanzhof (14.10.2015), IR 20/15 N 9 et seq. Of another opinion: HEUERMANN, p. 2.

[400] Bundesfinanzhof (14.10.2015), IR 20/15 N 1 et seq.

[401] Bundesfinanzhof (14.10.2015), IR 20/15 N 16 et seq.

[402] Bundesfinanzhof (14.10.2015), IR 20/15 N 17 et seq.

[403] Bundesfinanzhof (14.10.2015), IR 20/15 N 19. See also MÜNCHEN/MÜCKL, p. 1472.

[404] See e.g. HEUERMANN, p. 2 et seq.

[405] See e.g. HEUERMANN, p. 3.

[406] Bundesfinanzhof (14.10.2015), IR 20/15 N 28 and 30 et seq.

[407] Bundesfinanzhof (14.10.2015), IR 20/15 N 42 and 44 et seq.

These explanations cannot be transferred as such for Swiss purposes. However, it seems clear that the non-deductibility of interest expenses, which are justified on business grounds, violates the ability-to-pay principle.[408] Indeed, such principle states that companies are to be taxed on the periodic increase of their ability to pay taxes.[409] It follows that payments, which are justified on commercial grounds and reduce the ability of the company to pay taxes, must be taken into account when calculating the taxable profit.[410] Therefore, the basic concept of the OECD/G20 recommended approach, i.e. a fixed ratio rule based on the EBITDA, without any adjustments, would violate the Swiss ability-to-pay principle.[411] It shall be examined (i) whether and, if applicable, (ii) how an interest limitation rule based on the OECD/G20 recommended approach could be designed in conformity with the federal Constitution. This question cannot be exhaustively assessed in the context of this thesis. Nonetheless, it can be stated that a rule, according to which companies would not be granted the possibility of carrying back or forward disallowed interest expense and/or unused interest capacity, would most probably violate the ability-to-pay principle.[412] Moreover, one would need to clarify whether possible exceptions (such as public-benefit projects or *de minimis* thresholds) are incompatible with the constitutional principles or, on the contrary, could render the rule compatible with the ability-to-pay principle. Finally, the two aforementioned justifications pointed out in Germany would be inapplicable in Switzerland as the interest limitation rules should not aim to secure tax substrate and no qualified fiscal purpose exists in Swiss law.

7.2.3 Conformity with Article 9(1) OECD-MC

As outlined in section 6.1, if the interest limitation rules are only used as safe harbour and do not prevent the taxpayer from demonstrating that the financing is at arm's length, there is generally no breach of article 9(1) OECD-MC.[413] However, unlike the Swiss interest limitation rules, the OECD-G20 recommended approach does not provide the taxpayer with the possibility to prove that an interest paid is justified on business grounds, respectively is at arm's length. The reconciliation of such recommended approach with article 9(1) OECD-MC is therefore of particular importance and has given rise to much debate in the literature.[414] There

[408] HONGLER/BÖHI, p. 140 et seq.

[409] From a dogmatic point of view, the taxable profit would need to be determined at the time of liquidation (*total profit principle*). However, for the sake of practicability, the taxable profit is determined in the company's financial periods. See section 2.3.3.

[410] HONGLER/BÖHI, p. 140.

[411] HONGLER/BÖHI, p. 140 et seq.

[412] HONGLER/BÖHI, p. 151.

[413] BURKHALTER-MARTINEZ, p. 59 et seq.; OECD-MC, Commentary 2017, art. 9 N 3(a). However, the arm's length test must be carried out in accordance with the DTA obligations, see HONGLER/BÖHI, p. 143.

[414] MARRES, p. 44 et seq.; FROSS, p. 511 et seq.; ASIMAKOPOULOS, p. 406 et seq.; CENCERRADO/SOLER ROCH, p. 61 et seq.; BAMMENS, p. 149 et seq.; PILTZ, p. 69 et seq.; FROSS/HEMMERLE, p. 207; KEMMEREN, N 3.2.1; EIGELSHOVEN, art. 9 N 28a et seq. OECD-MC; LÜTHI, p. 586 et seq. See also regarding the influence of the final BEPS reports on the interpretation of DTAs: HONGLER/BÖHI, p. 144 et seq.

have also been several judgments of foreign courts in this regard.[415] The following remarks should provide an overview of the discussion regarding the conformity of the BEPS/G20 recommended approach with article 9(1) OECD-MC.

The commentary on article 9(1) OECD-MC states that: "the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying tax treaties".[416] This principle acknowledges the fact that article 9(1) OECD-MC should be interpreted as being restrictive to the domestic law of both contracting states, in the sense that the latter should not attribute profit to an enterprise that would exceed the profit at arm's length.[417] As the recommended approach encompasses both financings between associated and independent enterprises, the next question arising is whether article 9(1) OECD-MC also covers transactions between non-associated enterprises. The positions differ widely among scholars. It seems that the prevailing doctrine, which is also the most convincing in the author's view, is of the opinion that domestic law is only restricted in its application as far as transactions between related parties are concerned.[418] This follows the wording of article 9(1) OECD-MC, which does not mention independent enterprises in its personal scope.

Moreover, some scholars consider that interest limitation rules, which do not provide the taxpayer with the possibility to demonstrate that its financing was concluded under market conditions, could be consistent with article 9(1) OECD-MC if they constitute *general rules for the determination of taxable profit*.[419] Since the determination of the tax base is beyond the scope of the treaty provision, such interest limitation rules would not fall within the scope of article 9(1) OECD-MC.[420] Further, such provision does not constitute a general prohibition against interest deduction limitation rules but rather allows a contracting state to adjust the profit of an associated enterprise in a specific transaction when such profit is not at arm's length.[421] For the scholars supporting this view, the application of a thin capitalisation regime

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[415] See MARRES, p. 47 et seq. and BAMMENS, p. 163 et seq. for a summary of the cases *Specialty Manufacturing Ltd*. (18 May, 1999, Canadian thin capitalisation rule) and Andritz Sprout Bauer (30 December, 2003, French thin capitalisation rule). See also ERNST & YOUNG, p. 1 et seq. regarding the decision of the Spanish Supreme Court as of 17 March, 2011, which annulled the restriction on interest deductibility in a particular case based on the argument that art. 9(1) OECD-MC only allows states to adjust profits between associated companies if the arm's length principle is infringed. One consequence of this ruling was that the Spanish debt limit was replaced in 2012 by an earnings limit.

[416] OECD-MC, Commentary 2017, art. 9 N 3.

[417] Regarding the restrictive nature of art. 9(1) OECD-MC and the question as to whether this provision permits the characterisation of the excessive amount of debt into equity, see FROSS, p. 510 et seq.; MARTINHO FERNANDES, p. 271 et seq.; MARRES, p. 40 et seq.; BURKHALTER-MARTINEZ, p. 59.

[418] BURKHALTER-MARTINEZ, p. 60; FROSS, p. 511; FROSS/HEMMERLE, p. 212. Of other opinions: EIGELSHOVEN, art. 9 N 28b OECD-MC and the references mentioned.

[419] FROSS, p. 515; HONGLER/BÖHI, p. 143 et seq.; BURKHALTER-MARTINEZ, p. 60; KEMMEREN, N 4.1.1.

[420] FROSS, p. 515; KEMMEREN, N 4.1.1; LINN, p. 345. Other opinions: KÖHLER, p. 604; EIGELSHOVEN, art. 9 N 28b OECD-MC.

[421] HONGLER/BÖHI, p. 143 et seq.; BURKHALTER-MARTINEZ, p. 60.

could, therefore, result in non-associated enterprises having a higher tax base than market conditions (in line with the arm's length principle) would suggest.[422] However, for these scholars, the tax deductibility of interest is a matter of domestic law and should therefore not be limited by article 9(1) OECD-MC.[423]

In conclusion, the conformity of the BEPS/G20 recommended approach with article 9(1) OECD-MC is still controversial and there is presently no international consensus. However, in the author's view, only interest limitation rules which target specific transactions (e.g. a loan agreement) between associated enterprises fall under the scope of article 9(1) OECD-MC. As the BEPS/G20 recommended approach is intended to apply to interest expenses paid to related and unrelated parties, it should, assuming it applies not only to MNEs but also to domestic groups as well as to standalone entities[424], be considered as a *general rule for the determination of taxable profit*. Therefore, there would be no breach of article 9(1) OECD-MC.[425]

7.2.4 Conformity with Articles 24(4) and 24(5) OECD-MC

Assuming the BEPS/G20 recommended approach is considered as a *general rule for the determination of taxable profit* and, therefore, does not fall under the scope of article 9(1) OECD-MC[426], the carve-out of article 24(4) OECD-MC would not be applicable, and the recommended approach should be tested against the principle of non-discrimination of article 24(4) and 24(5) OECD-MC or the corresponding provisions in the tax agreements concluded by Switzerland.

As outlined above, according to article 24(4) OECD-MC, interest payments paid to a lender residing in another state must be deductible under the same conditions as if they had been paid to a resident of the same state of the borrower. Thus, all discrimination based on the residence of the interest recipient is prohibited.[427] The OECD/G20 stated in its Action 4 Final Report that entities in multinational groups pose the main BEPS risk and that, therefore, it may be appropriate for a country to restrict the application of the fixed ratio rule to these entities.[428] However, the OECD/G20 also indicates that a country may choose to apply the fixed ratio rule

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[422] HONGLER/BÖHI, p. 143; BURKHALTER-MARTINEZ, p. 60.

[423] HONGLER/BÖHI, p. 143. However, this could lead to double taxation if no offsetting adjustment is made in a cross-border context.

[424] According to the OECD/G20, the recommended approach should at least apply to all entities in multinational groups, although countries may apply it to entities in a domestic group and/or standalone entities. See OECD/G20, 2016 Update, N 44 et seq.

[425] Same opinion: HONGLER/BÖHI, p. 143 et seq.; MARRES, p. 46; BURKHALTER-MARTINEZ, p. 62. The conformity with article 9(1) OECD-MC would, therefore, depend on the implementation of the recommended approach.

[426] For an analysis of the conformity with art. 24(4) OECD-MC in case the recommended approach is regarded as falling under art. 9(1) OECD-MC, see BURKHALTER-MARTINEZ, p. 63.

[427] See section 6.4.3.

[428] OECD/G20, 2016 Update, N 49.

also to entities in domestic groups[429] as part of a broad approach to tackle BEPS or "in order to meet other policy goals, such as to avoid competition issues between domestic and multinational groups […], or to comply with constitutional obligations for the equal treatment of taxpayers".[430] Thus, if a country limits the application of the recommended approach to multinational groups, interest payments made to non-resident entities may not be deductible based on the new rule implemented although they would have been deductible if they had been paid to resident entities.[431] In such a case, the new rule could be regarded as inconsistent with the principle of non-discrimination of article 24(4) OECD-MC.[432] In contrast, assuming the BEPS/G20 recommended approach is applied not only to MNEs but also to domestic groups as well as to standalone entities, there would be no infringement of article 24(4) OECD-MA as no discrimination based on the residence of the interest recipient would occur.[433]

Article 24(5) OECD-MC states that domestic enterprises held wholly or partly, directly or indirectly, by foreign persons may not be subject to a less favourable tax treatment than domestic enterprises with domestic shareholders.[434] Because the recommended approach is intended to apply to all interest payments, be it to related or unrelated parties, and, therefore, does not exclusively target interest payments made to non-residents by which the debtor company is owned or controlled, there would be no discrimination in the sense of article 24(5) OECD-MC.[435]

7.2.5 Assessment

As stated above, in order to comply with the constitutional rules, especially article 127 FC[436], a possible implementation of the recommended approach of the OECD/G20 in Switzerland would have to provide the companies with the possibility of carrying back or forward disallowed interest expense and unused interest capacity.[437] The OECD/G20 states that the arm's length test "[…] could ensure that the amount of interest expense claimed by an entity is in accordance with the arm's length principle, but this amount is then subject to limitation under the best practice approach in this report".[438] Thus, through the application of the fixed ratio to related and unrelated parties, an arm's length test alongside the BEPS/G20

[429] I.e. groups which operate wholly within a single country, see section 5.1.
[430] OECD/G20, 2016 Update, N 49.
[431] BURKHALTER-MARTINEZ, p. 64.
[432] BURKHALTER-MARTINEZ, p. 64. See BSK OECD-MC-OESTERHELT, art. 24 N 133, according to which a discriminatory taxation exists when the fact that the recipient is resident in another contracting state results in less favourable tax treatment in the debtor's country.
[433] See HONGLER/BÖHI, p. 145 and 150; RUST, art. 24 N 145 OECD-MC.
[434] See section 6.4.3.
[435] BURKHALTER-MARTINEZ, p. 65; BAMMENS, p. 165.
[436] See section 2.2.
[437] See section 7.2.2.
[438] OECD/G20, 2016 Update, N 59.

recommended approach would not have any effect.[439] Even if the OECD/G20 does not forbid the arm's length test explicitly, it would then make no sense for Switzerland to keep such test as it would be devoid of its substance.[440] In order to comply with article 9(1) OECD-MC, the implementation of the OECD/G20 recommended approach would, therefore, have to constitute a *general rule for the determination of taxable profit*.[441] For this purpose, it would have to apply not only to MNEs but also to domestic groups as well as to standalone entities.[442] In such a case, the new rule would also be in accordance with article 24(4) OECD-MA.[443] Finally, provided that the new rule does only not target interest payment made to non-residents owning or controlling the resident's company capital, no violation of article 24(5) OECD-MC would occur.

The next question arising is whether Switzerland *should* introduce such a fixed ratio recommended by the OECD/G20 that complies with constitutional rules[444] and double taxation conventions, i.e. a rule that allows the companies to carry back[445] or forward disallowed interest expense and unused interest capacity and also applies to domestic groups and standalone entities. For Switzerland, the main advantage of the introduction of the OECD/G20 recommended approach would, without doubt, lies in the international acceptance.[446] Switzerland is one of the relatively low-tax countries of the OECD and is subject to intense pressure from the major European countries, which see their tax substrate eroded by profits shifting.[447] However, the introduction of the recommended approach, which is not restricted to interest payments to related parties (like the current regulation[448]) but also covers interests to be paid to third parties, would lead to a massive restriction of the freedom of financing.[449] Such a restriction conflicts with the legislator's intent, according to which no requirement should be imposed on companies' financing, except for banks and insurances.[450] Like the current rule, the recommended fixed ratio rule would prevent abusive debt financing. However, it will also restrict external financing, which takes place on the free market. This is

[439] BURKHALTER-MARTINEZ, p. 62.

[440] Regarding the introduction of a saving clause in order to ensure the avoidance of conflict with tax treaty provisions, see BURKHALTER-MARTINEZ, p. 63; HONGLER/BÖHI, p. 143.

[441] See section 7.2.3. See also HONGLER/BÖHI p. 151.

[442] See section 7.2.3.

[443] See section 7.2.4.

[444] There is no constitutional jurisdiction in Switzerland so that in the (theoretical) case a new interest limitation rule not in conformity with the federal Constitution would be introduced in the FDTA and the FTHA, the Swiss Supreme Court would have to apply it nevertheless pursuant to art. 190 FC.

[445] It can be noted that the possibility to carry back a loss is unknown in the Swiss tax system and that some procedural changes would therefore be needed. See HONGLER/BÖHI, p. 151. See section 2.3.3 regarding the loss carried forward.

[446] HONGLER/BÖHI, p. 150.

[447] See e.g. section 2.4 regarding the abolition of the cantonal preferential tax regimes for holding, domicile and mixed companies.

[448] See sections 4.2 and 5.1.

[449] See HONGLER/BÖHI, p. 139.

[450] See HONGLER/BÖHI, p. 139 et seq.; GLANZMANN, p. 52 et seq.

not desirable from an economic point of view as it leads to a distortion of the competition rules. Further, the EBITDA, which serves as the only basis for the recommended fixed ratio rule, is subject to considerable fluctuations compared to the assets fair values that are currently used for determining the maximum interest capacity. The latter measure gives the companies more legal certainty and also more planning security. The abolition of the arm's length test would also harm the legal certainty for taxpayers. They will not be able to provide the tax authorities with transfer pricing documentation to justify their debt financing. The arm's length test allows taking into consideration the specifics of each industry, whose equity needs are different. In contrast, the recommended approach considers industry specifications only within the framework of the group ratio, what has been criticised.[451] Further, the radical change from an interest limitation rule, which is backed by a reliable and longstanding practice of the authorities, to a new rule based on a different concept would be imprudent and creates legal uncertainty. The deteriorated legal certainty as well as the recommended fixed ratio rule itself, which is less favourable for the taxpayer, would negatively impact the attractiveness of Switzerland as a business location. Finally, the introduction of the recommended approach would have only a limited effect on fighting BEPS as generally the relatively low taxation rate leads the lenders, rather than the borrowers, to be located in Switzerland.

To sum up, it seems that the drawbacks associated with the voluntarily introduction of the BEPS/G20 recommended approach outweigh the advantages, including the possible additional revenues that would result from such an introduction, at present. In the author's view, Switzerland should therefore not introduce an interest limitation rule pursuant to the OECD/G20 recommended approach.[452]

7.3 Option 2: Substance Over Form Approach

Even if Switzerland does not introduce the BEPS/G20 recommended approach, it must bring into line the wording of the law (art. 65 FDTA, 24(1)(c) and 29*a* FTHA) and the practice of the tax administration set out in Circular No. 6. The current practice of the SFTA is – subject to the arm's length test – based on asset/debt ratios and follows a *form over substance* approach, according to which the conditions of the debt (such as the subordination and the repayment period) are not taken into account.[453] As stated above, such practice is not compatible with the wording of the law that aims at an economic approach following a *substance over form* approach.[454] Therefore, option 2 would be to change the practice of the tax authorities towards a *substance over form* approach.[455] The relevant debt would need to have the economic

[451] HUBER/MAHAWATTAGE/BERR/MEYER-NANDI, p. 310.

[452] At present, the Swiss government has no intention to introduce such a rule, see section 5.2.

[453] See section 4.3.

[454] See sections 4.2 and 6.3.

[455] Option 2 is therefore addressed to the tax and judicial authorities, and not primarily to the legislator. See HONGLER/BÖHI, p. 146.

functions of equity, as defined in section 3.1.1, in order to justify reclassification. In other words, a reclassification as deemed equity would be possible if (i) no relevant economic features of debt are left and (ii) the business risk of the creditor is equal to the business risk of the equity investors.[456] Further, the financing should be provided by shareholders or parties related to them and not by independent third parties.[457]

The proof that debt economically corresponds to equity capital and should, hence, be reclassified as such is currently not provided by the tax authorities.[458] With an adaptation of the current practice of the tax authorities towards a *substance over form* approach, the correct implementation of the legal text could be achieved administratively.[459] Such a solution would conform with the ability-to-pay principle and therefore also with the federal Constitution.[460] It would also comply with the OECD-MC, respectively the double taxation agreements concluded by Switzerland as it does not differentiate between domestic and foreign situations and the arm's length test is reserved.[461] Option 2 would accordingly have some advantages, but it would also be associated with some uncertainties since the differentiation between debt and equity from an economic point of view can be very complex, and no authoritative criteria exist for this purpose.[462] This fact can be illustrated with hybrid financing instruments, such as preferred shares, convertible bonds or shareholder loans, which have both debt and equity characteristics. In contrast, the current safe haven practice of the tax authorities guarantees legal certainty to taxpayers, which in turn contributes to the stability and the attractiveness of Switzerland. Accordingly, in the author's view, option 2 would not be suitable for Switzerland as it is linked with too many uncertainties.[463] The practice of the tax and judicial authorities should yet be in accordance with the wording of the law. Hence, other options need to be contemplated.

7.4 Option 3: Genuine Legal Thin Capitalisation Rule

In order to eliminate the contradiction between the legal basis (art. 65 FDTA, 24(1)(c) and 29*a* FTHA) and the current practice of the SFTA, one could amend the legal provisions by incorporating the rules of the Circular No. 6 into the law *de lege ferenda*. Concretely, the new law would have to prevent abusive undercapitalisation but without requiring examining whether the debt economically corresponds to equity on the basis of a functional analysis.[464]

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[456] See section 6.3.

[457] See section 4.4.

[458] HONGLER/BÖHI, p. 146. See also the judgment of the Swiss Supreme Court BGer 30 September, 2015 (2C_560/2014).

[459] HONGLER/BÖHI, p. 147.

[460] BÖHI, verdecktes Eigenkapital, p. 178 et seq.; HONGLER/BÖHI, p. 147.

[461] HONGLER/BÖHI, p. 147.

[462] As stated in section 3.1.3, the limits between debt and equity financing are blurred from an economic point of view.

[463] Same opinion: HONGLER/BÖHI, p. 147.

[464] HONGLER/BÖHI, p. 147; HONGLER, Finanzierungsinstrumente, p. 65.

Like Circular No. 6, the new rule would be based on asset/debt ratios and would include an arm's length test.[465] It can be left open whether the new rule should state the minimum taxable equity for different industries (such as real estate or finance), like the first draft of the interest limitation rules[466], or refer to an ordinance stating the debt capacity according to the types of assets.[467] Because of the arm's length test, such new rule would in principle be compliant with the constitutional principles, as the interest not justified on business grounds would not be deemed to reduce the ability-to-pay of the taxpayer.[468] Further, it would also conform with articles 9(1) and 24(4) OECD-MC or the relevant double taxation conventions[469].

Asset/debt (as well as equity/debt) ratios remain an internationally widespread method of preventing abusive debt financing.[470] Because of this international acceptance and with regard to the fact that the BEPS Action is not a minimum standard, one can assume that Switzerland will not be internationally marginalised if it does not follow the BEPS/G20 recommended approach.[471] Indeed, the OECD/G20 acknowledges that the asset-based approach could be an "acceptable alternative" to earnings-based approach, especially for countries highly reliant on heavily capitalised groups whose activities rely on tangible fixed assets.[472] Another advantage of such rule would be that the existing practice and the related experience of tax administrations and taxpayers would continue to be relevant.[473] The administrative practice on deemed capital is in many respects clear, precise and offers unambiguous solutions.[474] Compared to earnings-based methods, the use of asset values gives rise to a relatively steady and predictable limit on the level of interest deduction that can be claimed.[475] For example, an approach based on asset values would mean that entities with losses would still be able to deduct an amount of interest expense, what may not be possible under an earnings-based approach.[476] An asset-based approach would ensure to keep the legal certainty and practicability that characterise Circular No. 6.[477] This, in turn, is beneficial for the attractiveness of Switzerland as a business location.

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[465] See section 4.3.

[466] See section 4.2.2.

[467] In the latter case, attention should be paid to the principle of legality.

[468] HONGLER/BÖHI, p. 148.

[469] See sections 6.1 and 6.4.3.

[470] KAHLENBERG/KOPEC, p. 91. Regarding the different kinds of thin capitalisation rules existing, see MARQUART, p. 141 et seq.

[471] HONGLER/BÖHI, p. 147.

[472] OECD/G20, 2016 Update, N 83.

[473] HONGLER/BÖHI, p. 148.

[474] HONGLER/BÖHI, p. 148. See, for example, the questions that have already been clarified by the Swiss Supreme Court regarding functional currency, compensation of adverse balance and subordinated debt, section 4.7.

[475] OECD/G20, 2016 Update, N 79.

[476] OECD/G20, 2016 Update, N 79.

[477] BSK FDTA- BRÜLISAUER/DIETSCHI, art. 65 N 62 et seq. See also MARTINHO FERNANDES, p. 46.

One drawback of the new rule would be that it still allows the taxpayer to manipulate the debt capacity to a certain extent as the composition of the assets can be changed with regard to the year-end figures (e.g. listed shares could be sold for cash, as cash has a higher debt capacity).[478] HONGLER/BÖHI have argued that another issue with the asset/debt ratios of Circular No. 6 is that the maximum interest capacity can be more or less artificially increased by the injection of borrowed capital, especially with regard to the fact that cash can be backed at 100% by borrowed capital.[479] These authors, hence, propose to switch to a debt/equity ratio, whereas an injection of debt capital would not automatically lead to an increase in the interest capacity and thus to an increase in the profit shifting potential.[480] In the author's view, this argument might be accurate for enterprises, which receive debt from related parties for the only purpose of being able to deduct the interest expense paid on it and which therefore might keep it in cash to increase their interest capacity. For those enterprises, which may especially be multinationals, available debt capital could in theory be taken up unlimitedly and a switch to a debt/equity ratio would, hence, be advisable from a tax policy perspective. In contrast, for most of the domestic enterprises, the debt capital received from related parties will be used to buy assets (such as plants or equipment) or to cover current expenses (such as payroll or rent) without being able to capitalise such costs. In such situations, it would be better to stick with the asset/debt ratios as this approach better takes into consideration the composition of the balance sheet of the individual taxpayer and so, the actual use of the debt.

Considering the advantages and drawbacks of Option 3, it would, in the author's view, make sense to implement the current practice of the SFTA in the law *de lege ferenda* and to introduce a debt/equity ratio for certain types of enterprises or specific situations, if deemed necessary and after a detailed examination of the implications linked to it. It would also have to be analysed whether the legal consequences of an exceeding interest expense should be a disallowance of such interest expense or a reclassification as deemed dividends.[481] On the one hand, the Swiss model, i.e. the reclassification, is related to the original objective of the legal provisions (the avoidance of double economic taxation) and is rather the exception in EU.[482] On the other hand, the reclassification creates additional withholding tax substrate, since the payment of interest between legal entities and/or individuals is generally not subject to withholding tax.[483] Further, the tax authorities are used to the reclassification of excessive interest expense in deemed profit distribution. In the author's view, the reclassification as

[478] HONGLER/BÖHI, p. 148. See also section 4.3.

[479] HONGLER/BÖHI, p. 149, with references to MARQUART, p. 143.

[480] HONGLER/BÖHI, p. 149.

[481] Regarding the question of whether the new rule should apply to domestic permanent establishments of foreign companies, see HONGLER/BÖHI, p. 150 and BÖHI, verdecktes Eigenkapital, p. 199 et seq.

[482] MARQUART, p. 149. Most EU countries have preferred the disallowance model as this reduces the risk of non-compliance with the EU legislation and such model can also be applied to independent parties, see HONGLER/BÖHI, p. 150.

[483] See section 3.2.2.

deemed dividends should therefore be kept. Lastly, according to the principle of legality, the wording of the law should clearly exclude from its scope the taxpayers subject to special regulatory rules regarding their capital requirements (e.g. banks and insurances).[484] The new rule should also include self-employed tax subjects, which maintain proper commercial accounts.[485]

7.5 Option 4: Abolition of Thin Capitalisation Rules

The Swiss thin capitalisation rules have primarily been introduced to limit the avoidance of the economic double taxation.[486] The reduction of the economic double taxation due to changes in the legal framework in the course of the Corporate Tax Reform II and at cantonal level raises the question of whether this purpose is still accurate and whether provisions on interest limitation should not be abolished without replacement.[487] This question would eventually have to be answered by politics. However, one needs, in any case, to assess whether the secondary purposes of the thin capitalisation rules, i.e. (i) the prevention of BEPS and (ii) the limitation of the tax advantage of debt compared to equity financing[488], would be sufficiently addressed in Swiss tax law in case of the abolition of such thin capitalisation rules.

Various measures are already in place to prevent BEPS. Firstly, as stated in section 6.2, a GAAR has been developed as a judicial practice by the Swiss Supreme Court, according to which tax authorities have the right to tax the taxpayer's legal structure based on its economic substance under certain conditions.[489] Such GAAR is applicable at any time and could be used to prevent abusive debt financing[490], and thus limiting BEPS. Secondly, the Transfer Pricing Guidelines of the OECD now state that lenders without any relevant economic activities will not be entitled to profits in excess of the risk-free return if they do not have the effective control over the (risks of the) capital borrowed.[491] Thirdly and finally, the Swiss Supreme Court applies a narrower definition of permanent establishment in the outbound case than in the inbound case, making the erosion of the domestic tax base through foreign finance permanent establishments more difficult.[492] Therefore, it seems that the thin capitalisation rules are not necessarily needed for the prevention of BEPS.[493]

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[484] This is currently not the case, see sections 4.2.1 and 4.4.

[485] See section 4.2.3.

[486] See section 4.2.2.

[487] HONGLER/BÖHI, p. 139 and 152. See also KNÖLLER, p. 320 on the necessity for regulation.

[488] See section 4.2.4. See also BÖHI, verdecktes Eigenkapital, p. 70 et seq., with references, regarding the financing neutrality in tax law.

[489] See section 6.2.

[490] See section 6.2.

[491] OECD/G20, BEPS Actions 8-10 Final Reports, p. 10 et seq. See also HONGLER/BÖHI, p. 152. Such excess profits will be allocated to the party that does exercise the control over the capital borrowed and assumes the risks related to it.

[492] BGE 139 II 78, cons. 3.1. See also HONGLER/BÖHI, p. 152.

[493] Same opinion: HONGLER/BÖHI, p. 152.

Regarding the limitation of the tax advantage of debt compared to equity, a notional interest deduction on the surplus equity (the portion of equity exceeding the core equity) has been introduced in the FTHA in the course of the Corporate Tax Reform III, as exposed in section 2.4.[494] Such notional interest deduction contributes to improving the financing neutrality between debt and equity and strengthening the equity capital base.[495] Equity coverage rates according to the types of assets have been published in article 1 OSF. The notional interest rate applied to the surplus equity is based on the rate paid on 10-year Swiss federal bonds (art. 3(1) OSF).[496] This is problematic as such rate was below zero as of 31 December, 2019 and, therefore, the applicable rate should be 0% pursuant to article 3(1) OSF.[497] Another issue is that to be eligible to introduce such notional interest deduction, the cantons must demonstrate an effective taxation on income in the canton's capital city of at least 18.03 %.[498] Currently, only the canton of Zurich may (and did) introduce such notional interest deduction.[499] In consequence, the impact of the introduction of such notional interest deduction is minimal at the moment and in the author's view, debt is still largely preferred from a tax law perspective.

It follows that thin capitalisation rules are needed to limit the preferential tax treatment of debt, respectively to improve the financing neutrality between debt and equity. In addition, the advantage of the current practice (and its possible incorporation into the law *de lege ferenda*, see section 7.4), compared to the measures mentioned above to prevent BEPS, is the legal certainty due to the safe haven rules of Circular No. 6. The current practice has a certain protective effect for the taxpayers as it neutralises the risk of application of the general anti-abuse rule or other anti-abuse instruments.[500] This is beneficial for the attractiveness of Switzerland. Last but not least, the abolition of the thin capitalisation rules would lead to a reduction in revenues from corporate income and capital taxes as well as withholding tax. For these reasons, option 4 should not be recommended.

[494] See section 2.4 and art. 25*a*^{bis} FTHA.

[495] MATTEOTTI/ROTH, p. 717; HUBER/MAHAWATTAGE/BERR/BUCHER/BULARD, p. 446. According to the OECD/G20, the notional interest on equity capital is not treated as interest or payment economically equivalent to interest for the purposes of Action 4, see OECD/G20, 2016 Update, N 42. Regarding the international acceptance of notional interest deduction, see OESTERHELT/SCHENK, p. 69; STAUBLI/KÜTTEL/RÖLLIN, p. 731.

[496] Regarding the way the notional interest rate *should* be defined, see MATTEOTTI/ROTH, p. 718 et seq.; STAUBLI/KÜTTEL, p. 574; OESTERHELT/SCHENK, p. 66 et seq.

[497] However if the surplus equity is attributable to related parties, e.g. group companies, it is possible to apply a higher interest rate at arm's length, see art. 4 OSF and HUBER/MAHAWATTAGE/BERR/BUCHER/BULARD, p. 446.

[498] See section 2.4.

[499] See section 2.4.

[500] HONGLER/BÖHI, p. 152 et seq.

8 Summary and Conclusion

The objective of this thesis was to describe whether, and if applicable, how the BEPS Action 4 and the ATAD have impacted Switzerland's domestic interest limitation rules. This thesis also strived to analyse and evaluate how Swiss thin capitalisation rules should be designed from a tax policy perspective.

As shown in this thesis, Switzerland has not committed to implementing the best practice laid out in BEPS Action 4. It has not adopted and has not intended to embrace any change to its thin capitalisation rules. Further, because Switzerland is not part of the EU, it is not forced to introduce any measure contained in the ATAD, especially article 4 ATAD.

The Swiss thin capitalisation rules, which exist since more than 20 years and are provided in articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA, state that taxable profits shall include the interest owed on the portion of the debt which *economically corresponds* to equity capital. Following a *substance over form* approach, the debt must have the economic functions of equity to justify a tax reclassification as deemed equity. In order to provide legal certainty to taxpayers, the SFTA published safe haven rules (officially called Circular No. 6) related to the application and interpretation of these thin capitalisation rules. According to the practice of the SFTA, deemed equity is assumed to the extent that the debt capital originating from shareholders or persons related to them exceeds the admissible debt capital calculated with asset/debt ratios provided in Circular No. 6. As a consequence, deemed equity is then added to the taxable equity of the borrower for capital tax purposes. Further, interest on deemed equity is reclassified as constructive profit distribution (dividend) and added back to the taxable net profit of the borrower. Such interest is also subject to the 35% withholding tax. However, the taxpayer has still the possibility to prove that its specific debt financing is at arm's length, so that the excessive debt (interest expense) is not reclassified as deemed equity (constructive dividend).

Because of this arm's length test, the Swiss interest limitation rules are considered to be in line with the transfer pricing rules, including article 9(1) OECD-MC. A debate exists whether interest on deemed equity shall qualify as dividend (art. 10 OECD-MC) or interest (art. 11 OECD-MC) for tax treaty purposes. In the author's view, such interest on deemed equity should be qualified as interest, based on the wording of the OECD-MC. Further, the Swiss interest limitation rules are in line with article 24(4) and 24(5) OECD-MC as they do not treat domestic and foreign interest recipients differently. They also comply with Swiss federal constitutional principles. However, the current practice of the SFTA, provided in Circular No. 6, is not compatible with the legal concept of articles 65 FDTA as well as 24(1)(c) and 29*a* FTHA as it follows a *form over substance* approach, according to which the economic functions and the individual conditions of the debt (such as the subordination and the repayment period) are not taken into consideration.

From a tax policy perspective, Switzerland should, in the author's view, not introduce an interest limitation rule pursuant to the OECD/G20 recommended approach (option 1), irrespective of its design. Indeed, the drawbacks, which include the restriction of the freedom of financing, the reduced legal certainty, the negative impact on the attractiveness of Switzerland and the limited effect on fighting BEPS, outweigh the advantages resulting from such a rule, i.e. an increased international acceptance and possible additional revenues. Due to the complex distinction between equity and debt according to economic criteria, option 2, i.e. the tax authorities' change of practice towards a *substance over form* approach, is also not recommended for Switzerland as it is linked with too many uncertainties. However, in the author's view, it would make sense for Switzerland to implement the current practice of the SFTA in the law *de lege ferenda* (option 3), with a possible shift from debt/asset to debt/equity ratios for MNEs. Such a solution would be internationally accepted, foster legal certainty and ensure the attractiveness of Switzerland as a business location. The author also analysed a possible abolition of the Swiss thin capitalisation rules (option 4). He came to the conclusion that thin capitalisation rules are still needed to limit the preferential tax treatment of debt.

The latter element (option 4) touches upon the fundamental discussion as to whether a different tax treatment of equity and debt capital is still appropriate. In the course of the BEPS project, it seems that the focus has developed more on the distribution of the tax substrate rather than on combating abusive debt financing. In order to limit such abusive debt financing, and as an alternative to thin capitalisation rules, one could argue that the preferential tax treatment of debt should be abolished, respectively reduced, or that equity financing should be made more attractive from a tax law perspective. Indeed, at the International Fiscal Association's (IFA) 2019 Congress in London, a poll showed that 71.7% of taxpayers would have preferred the OECD to have tackled debt and equity bias, rather than limiting interest deductibility.[501] An attempt has been made in the course of the Corporate Tax Reform III in Switzerland with the introduction of a notional interest deduction, but its impact is marginal. The paradox with respect to regulating thin capitalisation is that the underlying issue was created by the legislator himself, namely by favouring the tax treatment of debt financing. It is hence questionable why the legislator should implement rules to prevent tax erosion if he has created the tax gap himself.[502] Would it not be better to (try to) achieve financing neutrality?

[501] MEHBOOB, para. 13.
[502] KNÖLLER, p. 321.

Appendix 1: Questions to be answered as part of the Eucotax Wintercourse 2020

A. Interest limitation rules applying prior to BEPS Action 4 and the ATAD

Describe your country's domestic interest limitation rules existing prior to the BEPS Action 4 Report and the ATAD:

1. Describe the general principles for the deductibility of interest payments in your country's domestic tax law.
    a) How is (deductible) interest defined in your country's domestic tax law? Does it apply to all payments economically equivalent to interest (for example, amounts paid under alternative financing arrangements such as Islamic Finance, foreign exchange gains and losses, etc.)? Is there a definition of interest for tax purposes?
    b) Under what general conditions is interest deductible for income tax purposes?
2. Does your country apply fixed ratio provisions limiting the deductibility of interest payments? Please describe the main features (see e.g. question B, 2, a)) of these rules.
3. Does your country apply other specific provisions – so-called "targeted rules" (as described in Chapter 9 of the BEPS Action 4 Report) limiting the deductibility of interest payments (such as thin capitalisation provisions, provisions targeting structured arrangements, provisions tackling payments to low tax jurisdictions or other SAARs, etc.)?
4. If your country applies rules as described in questions (2) and (3):
    a) Are these rules limited to cross-border interest payments or do they also target purely domestic interest payments?
    b) Are specific rules in place (such as a group ratio or equity escape rule) when applying these provisions to group companies?
    c) Do these rules equally apply to "financial undertakings" (such as banks, insurance companies, collective investment vehicles, etc.) or do different rules apply to these types of undertakings?
5. Is there any administrative guidance or case law available on the application of your country's domestic interest limitation rules and the interpretation thereof?

B. Implementation of BEPS Action 4 and the ATAD into domestic law

Describe the changes to your country's domestic interest limitation rules following the implementation of the BEPS Action 4 Report and the ATAD:

1. Has your country adopted any changes to the general principles governing the deductibility of interest payments?

2. Has your country adopted any changes to the general definition of (deductible) interest for income tax purposes (to include certain payments economically equivalent to interest, such as those mentioned under question A, 1, a)) or to the general conditions governing the deductibility of interest?

   Regarding the definition of exceeding borrowing costs which is enshrined in Article 2 ATAD, has your domestic legislation, or have administrative guidelines, provided for details or examples of the wording of the directive?

   It is reminded that Article 2 ATAD defines borrowing costs as "interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including, without being limited to, payments under profit participating loans, imputed interest on instruments such as convertible bonds and zero coupon bonds, amounts under alternative financing arrangements, such as Islamic finance, the finance cost element of finance lease payments, capitalised interest included in the balance sheet value of a related asset, or the amortisation of capitalised interest, amounts measured by reference to a funding return under transfer pricing rules where applicable, notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings, certain foreign exchange gains and losses on borrowings and instruments connected with the raising of finance, guarantee fees for financing arrangements, arrangement fees and similar costs related to the borrowing of funds".

3. In case your country did not yet provide for a fixed ratio rule prior to the BEPS Action 4 Report and the ATAD: Has your country now introduced such a fixed ratio rule?

   a) If yes, please describe the main features of this provision (ratio, definition of EBITDA, scope, exemptions,…):

      How is EBITDA defined for the purposes of the fixed ratio rule? How is non-taxable income (e.g. income exempt under a double tax convention – such as branch profits –, income exempt under a participation exemption regime, income exempt under a Patent Box, etc.) treated in this regard? Is all of this income excluded from the EBITDA calculation or are certain tax deductions/exemptions not filtered from the EBITDA?

      Has your country adopted a 30% ratio or a lower one?

(1) Are specific rules introduced (such as a group ratio and/or equity escape rule) when applying these provisions to groups of companies? If the answer is positive, how does it work? Do individual companies belonging to the group have to apply the interest limitation rule at their own level? Is it rather applicable at the consolidated level only? Is it possible for companies belonging to the group to conclude agreements regarding the transfer of borrowing costs between them for the purpose of implementing Article 4 ATAD?

(2) Does the fixed ratio apply only to cross-border interest payments or also to purely domestic payments?

(3) Does a *de minimis* threshold apply?

(4) Do specific rules or exemptions apply to "financial undertakings" (see question A, 4, c))? If yes, how are 'financial undertakings' defined in this respect (for EU-countries: did your country follow the definition (list) provided in art. 2(5) ATAD?)

(5) Do specific rules or exemptions apply to stand-alone companies?

(6) Do specific rules or exemptions apply to public benefit projects (such as public infrastructure projects)?

(7) Are there safe harbour rules which allow companies (or tax groups) exceeding the 30% EBITDA limit to deduct the exceeding borrowing costs? How do they work?

(8) How is the entry into force regulated? Are existing loans grandfathered?

(9) How are exceeding borrowing costs beyond the 30% EBITDA limit treated? May they be carried forward (and for how long)? How is the unused deduction capacity treated?

(10) May exceeding borrowing costs beyond the 30% EBITDA limit be recharacterized as hidden distributions and be subject to a withholding tax?

b) If no, is there a specific reason available as to why your country has not (yet) introduced such rules?

4. In case your country already applied a fixed ratio rule prior to the implementation of BEPS Action 4 and the ATAD:

a) Has your country amended this rule following BEPS Action 4 and/or ATAD?

b) If yes, please explain the nature of these changes. To what extent are these changes based on the guidance provided for by BEPS Action 4 and/or the rules provided for by the ATAD?

c) If no, is there a specific reason available as to why your country has not (yet) amended its domestic rules (e.g. for EU countries: was your country's fixed ratio rule deemed "equally effective" to the rules laid down in the ATAD, etc.)?

5. Has your country modified, adopted or abolished any "targeted rules" (see question A.3) following BEPS Action 4 and the ATAD? If yes, please explain the reason for these changes. Are they related or unrelated to the introduction of a new fixed ratio rule?

6. Has your country modified its domestic interest limitation provisions in relation to financial undertakings (see question A, 4, c)) following BEPS Action 4 and the ATAD (either modification of existing specific rules or introduction of specific rules)?

7. Is there any administrative guidance (and case law) available on the application of your country's modified domestic interest limitation rules and the interpretation thereof?

8. Has your country kept some interest limitation rules which existed before the implementation of ATAD, and which continue to apply in combination with the new rules?

C. Interaction of domestic interest limitation rules with other domestic or international tax rules

1. What is the nature of the relationship between your country's interest limitation rules and transfer pricing rules (e.g. can they be applied simultaneously, alternatively or does a certain hierarchy apply)? Are there specific rules, guidance or case law governing this interaction?

2. How do your country's domestic interest limitation rules interact with other domestic rules preventing BEPS (such as GAARs, "targeted rules" with respect interest limitation as discussed above, rules targeting hybrid mismatch arrangements or CFC rules)? Are there specific rules, guidance or case law governing this interaction?

3. How do your country's domestic interest limitation rules interact with other provisions or principles in your country's domestic law or constitutional law (e.g. the ability-to-pay principle or principle of non-discrimination) Are there specific rules, guidance or case law governing this interaction? Is there any controversy in your country on the question whether an interest limitation rule such as Article 4 ATAD complies with constitutional principles?

4. How do your country's domestic interest limitation rules interact with the rules laid down in the double tax conventions concluded by your country

(e.g. the arm's length principle laid down in article 9 of the OECD MC, the non-discrimination provision laid down in article 24(4) and 24(5) of the OECD MC)? Are there specific rules, guidance or case law governing this interaction?

Declaration of Authorship

I hereby declare:

- that I have written this thesis without any help from others and without the use of documents and aids other than those stated above;
- that I have mentioned all the sources used and that I have cited them correctly according to established academic citation rules;
- that I have acquired any immaterial rights to materials I may have used such as images or graphs, or that I have produced such materials myself;
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17 February, 2020 François Piller

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