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Financial Assistance in the Form of Upstream Loans in the Light of Certain Swiss Corporate and Tax Law Aspects

Upstream loans granted by Swiss companies to their parent or affiliated companies must in each case be examined in the light of certain specific restrictions and conditions imposed by general principles of Swiss corporate and tax law. These principles do generally also apply to a Swiss company transferring its liquid funds into a central cash management or cash pooling structure of the group.

1 Upstream Loans as an Event of Financial Assistance

As a starting point for our considerations, we assume a Swiss company to grant to its direct or indirect parent company (the "Parent") (or to another group company) a loan. Such loan is referred to below as "**Upstream Loan**". This term also includes "cross-stream" loans to affiliated persons or companies, but not "down-stream" loans to the direct or indirect subsidiaries of the Lender.

Upstream Loans can serve different purposes, including the following:

- I to enable the Parent to **finance the acquisition** of the Swiss Lender's shares from the former shareholder;
- I to finance on behalf of another group company **operating costs**, in **reduction of external bank debt** or a **financial restructuring**;

- I to transfer all or a substantial portion of the Swiss Lender's liquid funds to an affiliated company serving as the centralized **cash pool** or **cash management** entity for the group.

Beside making an Upstream Loan, a Swiss company can also provide financial assistance by other means, such as providing **security for the obligations of an affiliated company vis-à-vis third parties**, for example, in the form of a guarantee, a pledge or an assignment of assets (shares, inventory, intellectual property, bank accounts, accounts receivable, etc.). Thus, the analysis set forth below for Upstream Loans applies also - and even more - to such other forms of financial assistance.

If there are any minority shareholders, the granting of an *Upstream* Loan to the majority shareholder is subject to the protection of the specific interests of the minority shareholders.

2 The "Arm's Length" Principle in Inter-company Dealings

Swiss corporate law does not recognize the overall legal concept of integrated groups of companies. Consequently, the board of directors of a Swiss group company may not take a consolidated view and fulfill its fiduciary duty by merely considering the overall interests of the entire group of companies. It must, rather, assess and secure the financial status of the Swiss Lender **on an independent and stand-alone basis**,



focusing on the Lender's distinct identity and status as a legally independent corporate entity.

Consequently, Upstream Loans must generally meet **arm's length conditions**, as they would be requested by an unrelated third party, such as a bank, when granting the same loan to the same borrower. This means, generally, that:

- I the Swiss Lender should carefully consider **the borrower's creditworthiness as well as willingness and ability to repay the loan**;
- I the Upstream Loan should have customary terms of **duration, termination and amortization**;
- I the Upstream Loan should provide for **adequate interest to be paid regularly** (and not just accrued); and
- I the Upstream Loan should be **adequately secured** (for example by the borrower providing a pledge or a third party guarantee).

3 Swiss Corporate Law Implications of Upstream Loans

3.1 General

Each Upstream Loan by a Swiss Lender must be examined in the light of the **restrictions and conditions imposed by certain general principles of Swiss corporate and tax law**. In the absence of clear-cut case law, it is often difficult to assess whether and to what extent such general principles apply to the particular case. As a result of this dissatisfactory situation and given the potential consequences of their potential non-compliance with such principles, Swiss Lenders are often forced to take a prudent approach in this context.

Non-compliance may notably lead to the **invalidity of an Upstream Loan** as well as to **directors' and officers' personal liability**. Furthermore, non-compliance may have **adverse tax implications** (see Section 4 below) and may even, under certain conditions, qualify as a **criminal offense** (such as e.g. creditor preference or disloyal management) or as a **fraudulent conveyance** under the applicable provisions of Swiss **bankruptcy law**.

In view of these potentially harsh consequences as well as of various open questions surrounding the application of these general principles to Upstream Loans, it is advisable to analyze carefully in each case all restrictions and conditions set out below. This is particularly important where there are reasonable doubts as to whether the terms of an Upstream Loan are at arm's length.

3.2 Upstream Loan to be Covered by the Company Purpose

As a general rule, a commitment entered into on behalf of a Swiss company is binding on the company, to the extent it is within the company's business purpose, as set forth in its

articles of incorporation. If that is not the case, the commitment in question could be deemed *ultra vires* and thus null and void from the outset.

The fulfilment of this prerequisite is often questionable for Upstream Loans which are not entirely on arm's length terms. Whenever in doubt, it is advisable for the Swiss Lender to amend its articles of incorporation by extending the **purpose article to provide explicitly for the granting of financial assistance** to group companies, including through Upstream Loans. In addition, it may be advisable to insert in the articles of incorporation a clear reference to the fact that the Swiss Lender is part of a particular group of companies.

Such amended purpose article must be in effect at the time the Upstream Loan is granted, and requires a shareholders' resolution in the form of a public deed.

3.3 Upstream Loan to Comply with the Principle of Adequate Risk Diversification

As a general rule, the board of directors of a Swiss company must adhere to the principle of adequate risk diversification. When granting an Upstream Loan, the board of directors must thus **avoid an undue risk concentration** by a substantial portion of the company's balance sheet assets consisting of such a loan to a single borrower.

3.4 Upstream Loan to Comply with the Principle of a Diligent Liquidity Management of the Lender

When making an Upstream Loan, the board of directors of the Swiss Lender must always comply with the principle of **diligent liquidity management**. The longer the term of the Upstream Loan, the more difficult it is for the board of directors to assess the Lender's liquidity needs for such period.

3.5 Upstream Loan Not to Exceed the Lender's Free Equity

At least unless it clearly meets the arm's length test, an Upstream Loan may **not be given in an amount exceeding the Lender's so-called "free equity"**. Free equity corresponds to the amount of the Lender's total equity (as shown in the statutory balance sheet), minus 150% (or, in the case of a holding company, 120%) of the nominal issued share capital, minus any remaining special reserves which are not available for dividend distributions, such as any special paid-in surplus reserve (*Agio-Reserve*).

An Upstream Loan exceeding the free equity threshold could be deemed to be an unlawful return of the shareholder's capital contributions and to violate the statutory limitations on the use of the company's legal reserves. As a consequence, such Upstream Loan could be challenged by any party as being null and void from the outset. This is particularly true where such Upstream Loan has been **fictitious** or where it was **clear from the beginning that the borrower will not be in a position to repay the loan** when due.

3.6 Upstream Loan Not to Constitute a Constructive Dividend

Under Swiss corporate law, shareholders and related parties are obliged to return any benefits they received from a Swiss company if such benefits were clearly disproportionate to the consideration received by the company as well as to its financial status (so-called constructive dividends).

An Upstream Loan which does not clearly have arm's length terms could be deemed a constructive dividend. As a consequence, the board of directors of the Lender would be forced to demand immediate repayment of the loan irrespective of its term. The characterization as a constructive dividend would also lead to adverse tax consequences (see Section 4 below).

As a result, the **benefits of the party receiving an Upstream Loan must be adequately proportional to the consideration received by the Swiss Lender**. This requirement is often questionable in cases where the Upstream Loan is solely or predominantly for the benefit of the Parent or any of its affiliates. In such cases, it may be helpful and advisable to **amend the purpose article** in the Lender's articles of incorporation to explicitly allow for the granting of inter-company financing, even in cases where this is predominantly or solely for the benefit of the borrowing company.

In this context, it has become customary to require **formal approval** of Upstream Loans (which potentially qualify as constructive dividends) not only by the board of directors, but also by the **shareholders** of the Swiss Lender. However, this formal step as such does not necessarily prevent the Upstream Loan from being deemed a constructive dividend.

3.7 Directors' and Officers' Duty of Care

In general, the directors and the senior management of a Swiss company may become personally liable to the company as well as to its shareholders and creditors for any damage caused by an intentional or negligent violation of their duties.

Such liability may also be incurred by the Swiss company's Parent (and its corporate bodies) if the latter is deemed to be a **de facto corporate body** of the Swiss company.

In addition to the duty to apply the foregoing principles when granting an Upstream Loan, the Lender's directors and officers are under an **ongoing duty to verify carefully the creditworthiness of the borrower** during the entire term of the Upstream Loan and to **take immediately appropriate measures** if the borrower ceases to be creditworthy.

Moreover, according to the Swiss Withholding Tax Act, directors and officers may become **personally as well as jointly and severally liable for unpaid withholding tax obligations** of a Swiss company which is liquidated or becomes bankrupt. This liability is more strict than the general directors' and officers' liability insofar as the officers and

directors, in order to avoid liability, have to prove that they have done everything which could reasonably be expected from them to ascertain and fulfil the company's tax payables.

4 Swiss Withholding and Income Tax Implications of Upstream Loans

Ordinary as well as hidden profit distributions by resident companies are subject to Swiss withholding tax (currently at 35%) at source. Subject to certain conditions and upon request, the tax may be fully or partially refunded to the recipient of the profit distribution. For non-Swiss recipients, such a refund may only be granted based on a double tax treaty between Switzerland and the country of residence of the recipient.

Furthermore, profit distributions are not income tax deductible, why they are added back to the taxable profit of the distributing company and, therefore, become subject to corporate income tax.

From a tax standpoint, a constructive dividend is always assumed when a company executes non-arm's length transactions with related parties. This is also the case with regard to Upstream Loans, whereas the fulfilment of the arm's length requirement typically is assessed based on the following three elements:

- I **Interest Rate:** If the Upstream Loan is granted against an **interest rate** being lower than **accepted by the Swiss tax authorities for tax purposes**, any difference in the interest amount qualifies as a constructive dividend. The accepted interest rates differ from currency to currency and are published periodically by the Federal Tax Administration;
- I **Loan Amount:** Under certain conditions, the tax authorities might even characterize the total loan amount as a constructive dividend that is subject to withholding tax and income tax. This is the case if the Upstream Loan were **fictitious**, that is, if there had never been any intention of repaying the loan. Furthermore, such a characterization is possible if at the time the loan was granted or renewed, the borrower was in such a bad financial situation that **repayment of the loan could not reasonably be expected** or if at such time a **third party would not have granted or renewed such loan on substantially the same terms and conditions**;
- I **Liquidation Proceeds:** If the Upstream Loan is not paid back and if this leads to the bankruptcy or liquidation of the Swiss Lender, the granting of the Upstream Loan may be retroactively characterized as the first step in liquidation of the Swiss Lender under the **concept of factual liquidation**. As a result, Swiss withholding tax would be assessed not only on the amount of the Upstream Loan in question, but on the total amount of the (deemed) liquidation proceeds, calculated on the basis of the fair market values of the Swiss Lender's net assets at the time the Upstream Loan was granted.



Since the withholding tax of 35% must be withheld at source, the tax authorities consider the actual payment to be only 65% of the full constructive dividend amount. Hence, they first gross up the constructive dividend amount to 100% and then levy the 35% withholding tax on that basis. Consequently, the potential withholding tax liability of a Swiss Lender (or of its members of the board of directors or of the management, respectively) would amount to as much as 53.8% of the constructive dividend amount.

5 Conclusion

Before granting an Upstream Loan, a Swiss Lender is well advised to consider carefully the restrictions and conditions outlined above, especially where it is not clear whether the terms of the Upstream Loan are at arm's length. Given the complexity and uncertainties of the legal rules, each case requires individual in-depth analysis based on the specific circumstances.

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The content of this Newsletter does not constitute legal or tax advice and may not be relied upon as such. Should you seek advice with regard to your specific circumstances, please let your Schellenberg Wittmer contact person or any of the following persons know:

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