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Swiss Legal and Tax Implications of Social Impact Bonds

Social impact bonds (SIBs) provide private investors with an opportunity to earn a financial return which depends upon the measurable results achieved by a non-profit organization through a specific project. The funds to repay the investors are provided by donors (typically public bodies), whose contributions are linked to the outcome of the project. This contribution analyses the main Swiss legal and tax implications of SIBs. It also provides some lessons learned from the «Program for Humanitarian Impact Investment», a CHF 26 million SIB project launched in September 2017 by the International Committee of the Red Cross.

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Contents

- A. Introduction: what is a social impact bond (SIB)?
- B. Creation of the SIB
 - 1. Admissibility in light of the characteristics of the SIB issuer
 - 2. Creation of a special purpose vehicle (SPV)
- C. Distribution of the SIB
 - 1. Legal characterization of a SIB
 - 2. Overview of the applicable rules
 - a) Arguments in favour of a characterization as a loan agreement
 - b) Arguments in favour of a characterization as a bond
 - 3. Rules applicable to public bond offerings
 - a) Definition of a «public» bond offering
 - b) Swiss prospectus rules
 - c) Consequence of non-compliance with Swiss prospectus rules
 - 4. Practical impact on the distribution process
 - 5. Excursus 1: in-house fund
 - 6. Excursus 2: impact of the draft Swiss Financial Services Act
- D. Taxation of the SIB
 - 1. Swiss WHT
 - a) Is the issuer of the SIB a «bank for Swiss WHT purposes»?
 - b) Is the SIB a «bond for Swiss WHT purposes»?
 - c) Conclusion
 - 2. Swiss stamp tax
 - 3. Swiss VAT
 - a) Payments received by the SIB issuer from the outcome funders
 - b) Payments made by the SIB issuer to the social investors
 - 4. Tax implications for Swiss-resident investors
- E. Practical considerations drawn from the Program for Humanitarian Impact Investment (PHII)
 - 1. Presentation of the PHII
 - 2. Lessons learned

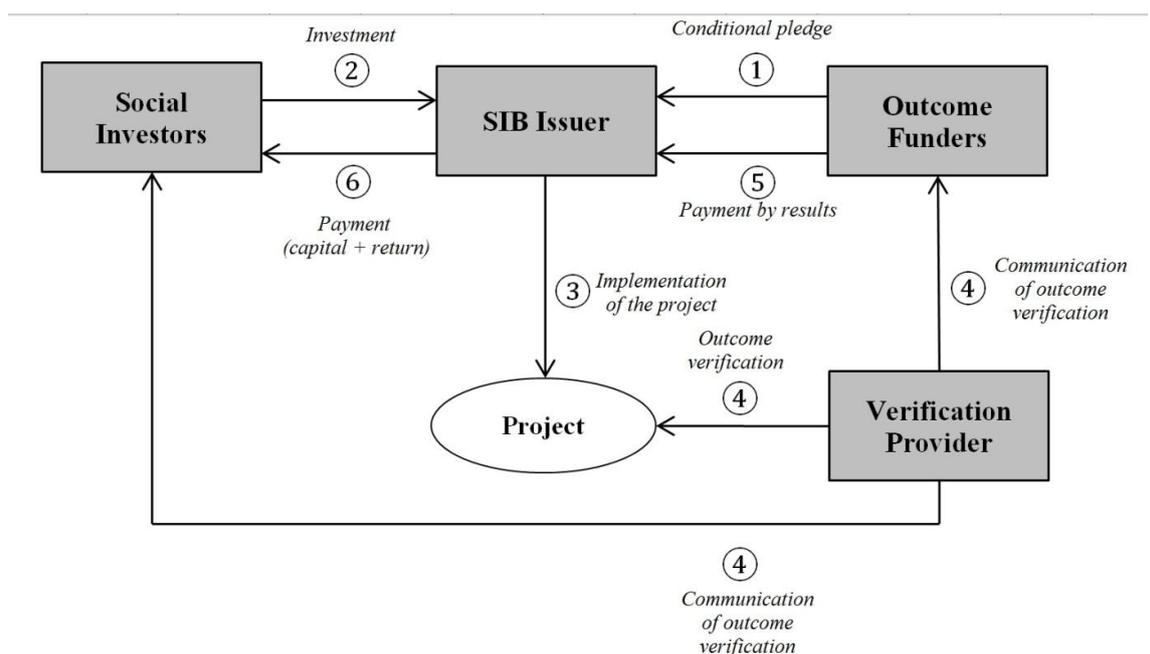
A. Introduction: what is a social impact bond (SIB)?

[Rz 1] In the last few years, a relatively new – and promising – funding approach to social, development and environmental projects has attracted considerable attention. Social impact bonds («SIBs») are designed to attract private investment capital to address society’s critical social needs.

[Rz 2] A SIB brings together donors (sometimes also called outcome funders), impact investors and non-profit organizations to fund impact in a performance-driven manner. SIBs offer investors an opportunity to make funds available to a non-profit organization and earn a financial return based on the actual impact of such activities, thereby making this funding an investment. Donors, in turn, can make performance-based donations that expressly link capital to impact. Non-profit organizations hold the steering wheel in carrying out the actual project and retaining control over how much money they need to raise over specific periods of time in order to achieve their objectives¹.

¹ LINDSAY BECK / CATARINA SCHWAB / ANNA PINEDO, SOCIAL IMPACT BONDS: What’s in a Name?, Stanford Social Innovation Review, 12 October 2016, available at https://ssir.org/articles/entry/social_impact_bonds_whats_in_a_name (all websited last accessed on 18 January 2018).

[Rz 3] In other words, instead of public bodies paying non-profit organizations directly to deliver services, private investors provide the initial funding and are repaid later by the public bodies (along with a possible profit) if the outcome of the services meets agreed upon performance benchmarks, which are verified by an independent auditor². Financing is hence ensured by the public sector on the basis of actual results, while pre-financing is provided by the private sector with the expectation of both a financial return and a social impact. The mechanism of a SIB can be illustrated as follows:



[Rz 4] Although the term «bonds» has been used to describe this method of financing and SIBs may, under certain circumstances, be characterized as bonds under certain applicable legal provisions³, SIBs do not function as bonds in the traditional financial sense. Rather, the SIB is a financing arrangement that allows non-profit organizations to enter into so-called «pay-for-success» contracts with donor governments, on the one hand, and private investors, on the other hand. SIBs essentially function as loans used to finance the timing delay inherent to «pay-for-success» contracts⁴. Although «pay-for-success» reflects the nature of the model, more accurately we will stick to the widely used and recognized term «social impact bond» (SIB) in this contribution.

[Rz 5] As promising and innovative as they are, SIBs also have unintended side effects. One of them is their being inaccessible to the smaller or newer non-profit organizations and, at least currently, being reserved mainly to the most well established ones by logically allocating them the bulk of SIB financing. This is due to the fact that the SIB model focuses on measurable social impact, combined with the need to provide financial returns to social investors. Another challenge is the seemingly high transaction cost of the initial SIB project (set-up cost), much of which has to be funded through contributions of other, more traditional donors. Finally, SIBs

² V. KASTURI RANGAN / LISA A. CHASE, The Payoff of Pay-for-Success, Stanford Social Innovation Review, Fall 2015, available at https://ssir.org/up_for_debate/article/the_payoff_of_pay_for_success.

³ See Section C. below as regards the characterization of SIBs from a Swiss legal perspective.

⁴ See RANGAN / CHASE (footnote 2).

may also generate a political backlash as they can be badly perceived by the public, who may see them as a system where social action is financialized and taxpayers' money is used to provide private investors with a financial return for projects of public utility.

[Rz 6] To date, more than 70 SIBs have been launched around the world since the first such scheme was initiated in the United Kingdom in 2010. In Switzerland, the first SIB scheme was launched in 2015 in the canton of Bern, where a group of entrepreneurs, the canton's public health and social authorities and the NGO Caritas teamed up to conduct a project aimed at supporting the quick and lasting integration of recognized refugees and temporarily admitting persons in the job market⁵.

[Rz 7] More recently, in September 2017, the first-ever «humanitarian impact bond» was launched by the International Committee of the Red Cross (the «ICRC»). This project is conceived as a way to finance the construction and operation of three new physical rehabilitation centres in the Democratic Republic of Congo, Mali, and Nigeria. It aims at expanding access to physical rehabilitation services for persons with physical disabilities who need a mobility device (see Section E. below for details).

[Rz 8] In this contribution, we will review, from the perspective of a Swiss non-profit organization willing to launch a SIB project, the main Swiss legal and tax issues which are to be taken into account in the design, elaboration and implementation of such a scheme.

B. Creation of the SIB

1. Admissibility in light of the characteristics of the SIB issuer

[Rz 9] The first question that we shall address is whether the project itself, *i.e.*, the SIB scheme, is admissible in light of the characteristics of the institution. Assuming that the SIB issuer is a non-profit organization, restrictions to the launch of a SIB may result from the requirements that apply to the organization's legal form under Swiss law or from other legal sources, such as its constitutive documents (statutes, by-laws or charter). Restrictions may also derive from self-limiting rules adopted by the organization or principles regarding the types of activities that it can carry out and the way it can function.

[Rz 10] As non-profit organizations in Switzerland are set up either as associations or as foundations, the admissibility of a SIB project must first be assessed in light of the statutory provisions applicable to these legal forms (Articles 60 *et seq.*, respectively Articles 80 *et seq.* of the Swiss Civil Code; SR 210) as well as relevant case law.

[Rz 11] In general, in order to be considered as «non-profit» (and hence to be suited for the legal form of an association or a foundation), the organization must have one or several statutory purpose(s) that are exclusively altruistic or charitable and aimed at achieving public benefits. While any *purpose* that entails the seeking of a profit for one or several person(s) is prohibited, Swiss law does not prevent a non-profit organization from conducting commercial, profit-making *activities* and actually generating financial revenues, to the extent of such activities being a means

⁵ For additional information on this project, see the press release published on 16 June 2015 by the Bern Cantonal authorities and available at: http://www.be.ch/portal/fr/index/mediencenter/medienmitteilungen.meldungNeu.mm.html/portal/it/meldungen/mm/2015/06/20150615_1458_erstmals_finanzierenprivatesozialeleistungenvor.

to achieve the ultimate charitable purpose(s). Associations in particular may conduct commercial activities and even carry out proper business activities if this supports their charitable purpose(s), provided however that such commercial activities remain secondary and are not the main focus of the association⁶.

[Rz 12] In practice, this means that any profit generated by a commercial activity carried out by the organization has to be entirely used for the non-profit activities (which can be limited to making grants to beneficiaries or consisting in concrete operations and projects) and not end up in the hands of members of the association.

[Rz 13] Because it involves borrowing funds from profit-seeking investors through a financial scheme under specific commercial conditions which include the payment of a premium to investors, launching and implementing a SIB project may be characterized as a commercial activity, which is traditionally undertaken by for-profit entities⁷. To the extent that the organization does not use such a scheme as its principal way of raising funds and the income generated through this scheme is used by the non-profit organization issuing the SIB in furtherance of its non-profit purpose(s), the project should be admissible from this perspective.

[Rz 14] Although it constitutes a financial instrument, a SIB does not actually yield commercial profits for the organization. In fact, only social investors are (possibly) making a profit, while the non-profit organization is simply tapping into an alternative source of funding in private investors and thereby temporarily bridging a time gap between immediate «alternative» funding and future «traditional» funding.

[Rz 15] Hence, another issue related to the admissibility of a SIB is whether one can consider that, for the organization to provide a financial return to investors, it is covered by the charitable purpose(s). However, this problem is irrelevant since the financial return is not paid by the SIB issuer but by the donor government(s) (outcome funder(s)) as part of their financing of the project on the basis of actual results. It is only if the organization performs under a certain threshold that it has to bear itself a portion of the actual costs of the project, which means that the organization, from a risk perspective, has to include a provision for under-funding of the project in its budget.

[Rz 16] Restrictions to the admissibility of a SIB project deriving from the organization's constitutive documents would exist only if such documents contain specific provisions limiting the organization's possible sources of income or the means to acquire funds. This is rarely the case in practice, as statutes of associations or foundations tend to be formulated quite broadly to allow for the greatest flexibility in the conduct of activities. In any case, even if such a restriction is embedded in the statutes, the organization would in most cases be able to modify or lift it through appropriate internal decision-making process.

2. Creation of a special purpose vehicle (SPV)

[Rz 17] A second question that arises when devising a SIB is whether the project requires the creation of a special purpose vehicle (the «SPV»).

⁶ See Article 61 (2) (1) of the Swiss Civil Code (SR 210), which provides that an association which is conducting commercial activities in furtherance of its (non-profit) goal is to be registered with the Trade Register.

⁷ This is evidenced by the content of the prospectus, if required; see below Section C.3.b).

[Rz 18] In this regard, several factors need to be considered in the assessment of the situation. A SPV is typically used to shield the organization from the financial risk associated with a specific business or transaction and can appear as particularly suited if said business or transaction falls outside of the scope of the organizations usual business activity. It also allows to isolate all the structural aspects of the SIB transaction, which can reinforce its trustworthiness and hence make it more attractive to investors and governments⁸.

[Rz 19] On the other hand, the same investors and donor governments (outcome funders) might have an interest in dealing with the non-profit organization directly and entrusting the funds that are necessary to carry out the actual project straight to it. This is typically the case if the organization is well-known, enjoys a wide recognition and already benefits from the trust of the stakeholders involved in the transaction. In this case, investors and outcome funders will likely be more inclined to participate in the scheme if the non-profit organization issues the loans itself without a SPV as intermediary.

[Rz 20] Because the SIB's primary function is to finance a social, environmental or humanitarian project, it also makes sense that the organization actually running the project financed by the SIB is the one issuing the loans. The organization needs to retain complete control over all project activities in order to optimize its performance, which will ultimately generate higher income for the social investors. In this regard, since all the risks related to the project are borne by the organization anyways, the creation of a SPV does not appear to be necessary.

[Rz 21] However, it is not unusual that social investors and outcome funders request a right to exert a certain influence during the implementation of the program and to withhold further funding if they consider that the SIB issuer is not acting in the best interests of the other parties or the project itself. This can justify the creation of a SPV to clearly separate the SIB project from the other activities of the organization.

[Rz 22] Finally, the argument of simplicity also plays a role. Because setting up a SPV creates additional layers of complexity, it substantially increases the transaction costs of an operation that is already relatively complex and costly to put in place⁹.

C. Distribution of the SIB

[Rz 23] As indicated in Section A. above, the SIB model requires the involvement of private investors, whose role is to pre-fund the activities undertaken in the context of the SIB. In this Section, we will analyze the aspects to be taken into account, from a Swiss legal perspective, in the context of the offering of a SIB to private investors.

[Rz 24] We will address the main rules applicable to the distribution of a SIB to Swiss-based investors. We will herein not discuss the rules applicable to the distribution of the SIB to in-

⁸ An issue which is separate from the set-up of an SPV is the concept that the funds to be received from the outcome funders may have to be sent to an escrow account, so as to provide comfort to the social investors that the allocation of these funds will be made in accordance with the terms of the SIB.

⁹ The structuring of the SPV and the relationship between the SPV and the SIB issuer must also be carefully reviewed from a Swiss tax perspective, so as to avoid any negative impact on the SIB issuer.

vestors located in other jurisdictions. Such analysis will have to be made locally in each relevant jurisdiction¹⁰.

1. Legal characterization of a SIB

[Rz 25] The Swiss legal framework sets forth specific documentation requirements which are applicable to the issuance of debt securities, generally referred to as «bonds» (*obligations d'emprunt / Anleiheobligationen*¹¹). By contrast, these documentation requirements do not apply if the relationship between the debtor and the creditor is characterized as a mere loan agreement. It is thus important to examine whether the relationship between the SIB issuer and the social investor is to be characterized (i) as a bond or (ii) as a loan agreement.

2. Overview of the applicable rules

[Rz 26] The law applicable to the offering/subscription process of the SIB must be distinguished from the law applicable to the SIBs themselves:

- If the issuer of the SIB is a Swiss legal entity, Swiss law is likely to apply to the legal characterization of the SIB and to the requirements applicable to the offering/subscription process.
- That being said, the Swiss rules regarding the offering/subscription process would also have to be taken into consideration by a non-Swiss issuer targeting Swiss-based investors. Under Swiss conflict of laws rules¹², an investor who has suffered a financial prejudice in a public offering of bonds or shares may elect to base its indemnification claim either on Swiss law (law of the place of offering) or on the law of the place of incorporation of the issuer. If Swiss law is chosen, the Swiss prospectus requirements would apply, including the liability rules in the event no prospectus has been prepared. Consequently, the non-Swiss issuer targeting Swiss-based investors is to observe the Swiss prospectus rules¹³.

[Rz 27] In light of the above, the legal characterization of the SIB is to be reviewed from a Swiss legal perspective. In Switzerland, a «bond» is defined as a large loan which has been divided into partial amounts, all of which are governed by the same terms and conditions regarding interest, issue price, duration, subscription period and payment date. The legal characterization of the SIB will depend upon the specificities of each case. We list hereinafter some of the features which are relevant in this context:

¹⁰ As far as the distribution within the European Union is concerned, the Markets in Financial Instruments Directive (MiFID I, respectively MiFID II as of 2018) provides for a uniform regulatory framework at EU level. In this context, the main question will be whether the SIB qualifies (i) as a «financial instrument» or an «investment service» (thus possible triggering the MiFID I/II requirements) or (ii) as a mere loan among private parties (that does not require any regulatory filing or authorization). In addition, the number of possible investors being approached will determine whether the SIB is subject to a prospectus requirement at EU level. These analyses are fact-specific and will have to be made on a case-by-case basis.

¹¹ Article 1156 SCO.

¹² Article 156 of the Swiss Private International Law Act.

¹³ It is to be noted, though, that the Swiss Supreme Court has held that Article 752 SCO (the provision dealing with prospectus liability) applies only to Swiss issuers (as opposed to non-Swiss issuers) (ATF 129 III 71, c. 2.3). That being said, in that same decision, the Swiss Supreme Court also held that the prospectus liability provision regarding bonds (Article 1156 (3) SCO) could apply to bonds issued by non-Swiss issuers (ATF 129 III 71, c. 2.3, see also decision of the Swiss Supreme Court 4C.245/1995 of 2 August 1996 published in SJ 1997 108, c. 5b).

a) Arguments in favour of a characterization as a loan agreement

- The total debt issued by the SIB issuer is not divided into notes with a certain denomination (e.g., there is no aggregate principal amount of, for example, CHF 100'000'000 divided into notes in the denomination of CHF 1'000).
- The principal amount extended by each SIB investor can be freely determined by each SIB investor.

b) Arguments in favour of a characterization as a bond

- The use of the term «bond» is an indication in favour of such a legal characterization, but is not decisive in this and of itself (Article 18 (1) of the Swiss Code of Obligations, the «SCO»).
- With the exception of the principal amount, the terms and conditions of all SIBs are identical. In our view, this factual point is crucial in the legal analysis in favour of a characterization as a «bond».

3. Rules applicable to public bond offerings

[Rz 28] If the conclusion is reached that the SIB is to be characterized as a *bond* (see Section C.2 above), the next question will be to determine whether the offering of the SIB is to be characterized as a *public bond* offering. This determination is important, because a *public* (as opposed to private) bond offering is subject to the Swiss prospectus rules.

a) Definition of a «public» bond offering

[Rz 29] The concept of a *public* bond offering is not expressly defined in Swiss law.

[Rz 30] A *public* offering is understood to be an offering made (i) to an indefinite number of investors or (ii) by means of a public advertisement (e.g., newspaper announcement, mass mailings, web page with unrestricted access). By contrast, an offering is deemed to be *private* if a limited number of selected investors are solicited individually by the issuer or a placement agent.

[Rz 31] A «rule of thumb» existed, according to which the threshold distinguishing a private placement from a public offering was set at 20 approached investors. This threshold was imported from the Swiss bank legislation, where the holding of more than 20 «deposits from the public» is one of the triggering criteria for the definition of a banking activity¹⁴. In a case law dealing with the public offering of interests in collective investment schemes¹⁵, the Swiss Supreme Court, however, focused on a *qualitative* approach, namely the requirement that a «limited circle of investors» is being approached. In light of this case law, the *qualitative* (as opposed to *quantitative*) approach is likely to also apply in the context of the determination as to whether a bond offering is of public or private nature¹⁶.

¹⁴ See Article 6 of the Swiss Banking Ordinance.

¹⁵ ATF 137 II 284, c. 5.3.

¹⁶ GAUDENZ G. ZINDEL / PETER R. ISLER, in: Heinrich Honsell / Nedim Peter Vogt / Rolf Watter (Ed.), *Basler Kommentar zum Obligationenrecht II*, Basel 2016, N 3 ad Article 652a SCO. See also PATRICK SCHLEIFFER / DAMIAN FISCHER,

[Rz 32] In light of the above, there is no bright-line test for determining whether an offering is public or private. Each offering must be assessed on a case-by-case basis, taking all the relevant facts (*e.g.*, marketing efforts, number and types of approached investors, relationship between approached investors) into consideration. That being said, in the absence of clear characteristics of a public offering (such as public advertising), an offering to up to 20 investors should, in our view, as a matter of principle, still qualify as a private placement, despite the fact that the case law mentioned above refers to a *qualitative* approach¹⁷. In specific cases, this threshold may be increased, in particular if it is possible to establish the existence of a relationship (for example a family relationship) between the investors being approached.

[Rz 33] The number of possible SIB investors *being approached* (as opposed to the number of SIB investors actually investing in a SIB) is relevant for purposes of determining the application of the Swiss prospectus rules. Furthermore, the assessment is to be made on a «look-through» basis, *i.e.*, in case of a two-step distribution process, by taking all investors into account to which the primary purchasers (underwriters) will assign the bonds¹⁸.

b) Swiss prospectus rules

[Rz 34] A *public* offering of bonds by a Swiss issuer must comply with the prospectus requirements set forth in the SCO. By contrast, non-public offerings of bonds in Switzerland are not subject to the prospectus requirements, as long as the bonds are not listed on a Swiss exchange.

[Rz 35] The Swiss prospectus requirements for bonds are set forth in Article 1156 SCO. By reference, this provision incorporates the content of Article 652a SCO, which is applicable to equity securities. The following information must be disclosed in an issuance prospectus pursuant to Articles 652a and 1156 SCO¹⁹:

1. the content of the entry in the commercial register of the issuer;
2. the amount and composition of the issuer's share capital (including number, nominal value and type of shares as well as preferential rights of certain categories of shares, if any);
3. the Articles' provisions of incorporation concerning the issuer's authorized or conditional share capital;
4. the number of profit sharing certificates and the rights connected therewith;
5. the issuer's latest annual statutory financial statements and the consolidated financial statements with the auditors' reports, and, if the closing of the balance sheet dates back more than six months, interim statutory and consolidated financial statements (which do not need to be audited);
6. the dividends paid during the last five years or since the date of incorporation;
7. the resolution on the issue of the securities;
8. the terms and conditions of the bonds (particularly regarding the interest payments, the reimbursement, the guarantees (if any) and the relationship between the bond holders).

Prospektfreie Platzierungen, in: Thomas U. Reuter / Thomas Werlen (Ed.), Kapitalmarkttransaktionen V, Zurich 2010, pp. 132 *et seq.*

¹⁷ See also ZINDEL / ISLER (footnote 16), N 3b *ad* Article 652a SCO.

¹⁸ See also ZINDEL / ISLER (footnote 16), N 3d *ad* Article 652a SCO.

¹⁹ It is to be noted that the amount and granularity of the information to be included in the prospectus will substantially increase in the context of the upcoming Swiss Financial Services Act, which is expected to enter into force in 2019 (Articles 42 *et seq.* of the draft Swiss Financial Services Act, see also Section C.6 below).

[Rz 36] These statutory provisions were drafted under the assumption that the issuer is a Swiss company. A number of the items listed above would have to be adjusted if the issuer is organized otherwise, for example in the form of a Swiss association.

[Rz 37] Under the rules currently in force²⁰, public offerings of debt or equity securities in Switzerland are not subject to any requirement of authorization by, or registration with, any Swiss governmental authority or self-regulatory body. That being said, the failure to prepare a prospectus may trigger a prospectus liability, as will be further addressed in the section below.

[Rz 38] In this context, one must also examine whether the activity of offering securities to the public is, as such, a regulated activity in Switzerland. As a matter of principle, the requirement for the offeror to obtain a license as a «securities dealer» only applies if such offeror is primarily active in the financial sector²¹. As regards the distribution of a SIB, the SIB issuer will generally fall outside the scope of these regulations, to the extent the SIB issuer (a non-profit organization) is not primarily active in the financial sector. In turn, a Swiss service provider which (i) is primarily active in the financial sector and (ii) is retained by the SIB issuer for purposes of the distribution process (as underwriter) will have to benefit from a license as a Swiss securities dealer.

c) Consequence of non-compliance with Swiss prospectus rules

[Rz 39] Non-compliance with the Swiss prospectus rules is enforced under Swiss law through a civil prospectus liability²². Such claims can be successful only if, *inter alia*, the plaintiff can establish causation. In other words, the plaintiff must show that the misstatement of information or the failure to provide certain information in the prospectus (or the failure to provide a prospectus even though such a prospectus would have been required) was an actual and adequate cause of the financial prejudice suffered.

[Rz 40] For example, if a prospectus did not record the dividend history of an issuer for the last five years, investors may only successfully recover damages from the issuer or anyone participating in the offering if they can prove:

- that they would not have bought the bonds, or would have bought them at a different price, had they been made aware of the information in question; and
- that the failure to provide the information caused the financial prejudice in question.

[Rz 41] If the misstatement or the failure to publish certain information cannot be linked to the financial prejudice in question, there should not be a cause of action for prospectus liability under Swiss law.

²⁰ The upcoming Swiss Financial Services Act, which is expected to enter into force in 2019, will introduce a requirement to register the prospectus with a public body (Articles 53 *et seq.* of the draft Swiss Financial Services Act, see also Section C.6 below).

²¹ Articles 2 and 3 of the Swiss Stock Exchange and Securities Trading Ordinance and FINMA Circular 2008/5, N 7. Special rules apply to the distribution of collective investment schemes. These rules will not be addressed here.

²² Articles 752 and Article 1156 (3) SCO.

4. Practical impact on the distribution process

[Rz 42] Assuming that the instruments issued in the context of a SIB are characterized as «bonds» from a Swiss legal perspective²³, it is important to examine whether the launch of the SIB results in a *public* offering of bonds.

[Rz 43] Despite the lack of definition of the concept of a *public* offering, we are of the view that the following general principles may be used as guidelines by the SIB issuer:

- if the number of possible investors being approached (as opposed to the number of SIB investors actually investing in a SIB) is below 20 and no public marketing initiatives are launched in respect of the SIB, it is unlikely that the Swiss prospectus rules are triggered;
- if the number of possible investors being approached is above 150²⁴, it is likely that the Swiss prospectus rules are triggered;
- if the number of possible investors being approached is between these two boundaries, (i) the manner in which the investors are approached (*e.g.*, a roadshow would be an argument in favour of a public offering) and (ii) the pre-existing relationships (if any) between the possible investors and with the issuer will be key items to determine whether or not the Swiss prospectus rules apply.

[Rz 44] In practice, it is often not possible to fully anticipate the number of possible approached investors at the outset of the SIB project. To the extent that the information to be provided under the current Swiss prospectus rules is rather limited²⁵, it is generally recommended to prepare a prospectus.

5. Excursus 1: in-house fund

[Rz 45] As an aside, one may want to consider an alternative structuring of the distribution process. As mentioned²⁶, the Swiss prospectus rules adopt a «look through approach», meaning that the number of end investors being approached is relevant, even if a Swiss bank acts as underwriter.

[Rz 46] If the investors in the SIB are clients of a specific bank, the possibility to structure the SIB as an «in-house fund» (*portefeuille collectif interne / internes Sondervermögen*) within the meaning of Article 4 (1) of the Swiss Collective Investment Schemes Act (the «CISA») should be considered:

- Under such a set-up, a Swiss bank (i) subscribes the SIB and (ii) allocates it to an in-house fund. The clients of the bank invest in interests in the in-house fund (as opposed to investing in the SIB).

²³ See Subsection C.2 above

²⁴ This is the number of targeted investors above which a prospectus is required pursuant to Article 3 (2) (b) of the EU Prospectus Directive, as amended by Directive 2010/73/EU, and pursuant to the draft Swiss Financial Services Act published by the Swiss Government on November 4, 2015. As far as the Swiss regulatory framework is concerned, the number of investors to which a security may be offered without triggering a prospectus requirement has been increased to 500 in the course of the Swiss parliamentary process (see Section C.6 below).

²⁵ See Subsection C.3.b) above.

²⁶ See Section C.3.a) above.

- Only clients that have entered into a written discretionary management agreement with the bank may invest in such in-house fund (Article 4 (2) (a) CISA). There is, however, no limitation on the number of managed clients who may invest in an in-house fund.
- In the (unlikely) event of a bankruptcy of the bank, the assets of the in-house fund are allocated to its investors and do not fall within the bankruptcy estate (Article 4 (3) CISA).
- The creation of such in-house funds is not subject to authorization by the Swiss Financial Market Supervisory Authority FINMA, but needs to be notified to the bank's regulatory auditors (Article 4 (2) CISA). There is no need to prepare a prospectus in respect of the in-house fund.

6. Excursus 2: impact of the draft Swiss Financial Services Act

[Rz 47] The Swiss prospectus rules will be modified by the upcoming Swiss Financial Services Act, which is expected to enter into force in 2019. Even though the revised rules will only be finally adopted by the Swiss Parliament in 2018, the following two changes, which may have an impact on SIB projects, will, in all likelihood, remain within the final version of the legislative overhaul:

- A *quantitative* threshold will be introduced to distinguish a private placement from a public offering. Under the revised rules, it will be possible to offer a security to 500 prospective investors without triggering a prospectus requirement²⁷.
- The in-house fund²⁸ will also be available to clients that have entered into a written advisory agreement (and not only a discretionary management agreement) with the bank which sets up the in-house fund²⁹. A basic information sheet (simplified prospectus) will have to be prepared in respect of the in-house fund. In our view, it is likely that the option of the in-house fund will become less attractive if the ceiling for the private placement is raised to 500 prospective investors, as mentioned above.

D. Taxation of the SIB

[Rz 48] In this Section, we shall first address the Swiss withholding tax (the «**Swiss WHT**») which is generally the most important tax aspect in the context of a SIB project (1.), as well as the Swiss stamp tax (2.). We will also discuss the treatment of the financial flows connected to a SIB project from a Swiss value added tax (the «**Swiss VAT**») perspective (3.). Finally, we will address the tax implications of an investment in a SIB from the perspective of Swiss-resident investors (4.).

1. Swiss WHT

[Rz 49] The Swiss WHT is due at the rate of 35% by the debtor of the taxable amount (dividend or interests). Article 14 (1) *Swiss WHT Act* provides that the 35% tax must be economically trans-

²⁷ Article 38 (1) (b) of the draft Swiss Financial Services Act.

²⁸ See Section C.5 above.

²⁹ Article 74 (1) and (2) of the draft Swiss Financial Services Act.

ferred to the beneficiary of the income. Should the withholding agent for Swiss WHT purposes fail to transfer the tax burden to its counterparty, the 35% (which have not been economically transferred) are considered as an additional amount subject to the 35% tax, leading to a gross-up of the tax burden to 53.8%³⁰.

[Rz 50] The Swiss-resident recipient of a payment which was subject to the Swiss WHT may request a refund of this tax. Regarding payment recipients located outside of Switzerland, the Double-Taxation Treaty concluded by Switzerland with numerous countries may allow a partial or full reduction of the Swiss WHT, from the perspective of the recipient (*i.e.*, the investor) of the payment which is subject to the Swiss WHT.

[Rz 51] As far as financing projects are concerned, it is important to stress that, as a matter of principle³¹, no Swiss WHT is due on interest payments under a traditional loan agreement. That being said, pursuant to the practice of the Swiss Federal Tax Administration (the «SFTA»), interest payments are subject to the Swiss WHT if:

- the interest payment is made by a «bank for Swiss WHT purposes» (see Subsection a) below);
or
- the interest payment is made in connection with a «bond for Swiss WHT purposes» (see Subsection b) below).

a) Is the issuer of the SIB a «bank for Swiss WHT purposes»?

[Rz 52] The Swiss WHT regulatory framework contains a definition of a «bank for Swiss WHT purposes», which is significantly broader than the definition of a «bank» under the Swiss Banking Act. The definition for Swiss WHT purposes covers (i) «banks» as defined in (Swiss and non-Swiss) banking regulations, but also (ii) any company that accepts funds on a regular basis, even if this is done for a limited number of persons.

[Rz 53] According to the practice of the SFTA³², a company may be characterized as a «bank for Swiss WHT purposes» if:

- it borrows funds from more than 100 non-banking lenders; and
- these borrowings exceed CHF 5'000'000 in total.

[Rz 54] For purposes of assessing the threshold of 100, only institutions which benefit from a banking license and which are conducting actual banking activities are excluded. Conversely, investment funds, pension funds and other similar institutional investors must be included in the computation of the 100 lenders.

³⁰ For example, an amount of 100 is subject to the Swiss WHT. If the Swiss WHT (35%) is not transferred economically to the counterparty, the amount of 100 will be deemed to be «without Swiss WHT». The base amount will thus be deemed to be 153, divided into 53 (35%) of Swiss WHT and 100 (65%) of principal.

³¹ Certain exceptions exist, but are unlikely to apply in the present context.

³² See SFTA Circular Letter n° 34 in relation to customer credit balances (26 July 2011).

b) Is the SIB a «bond for Swiss WHT purposes»?

[Rz 55] Again, the Swiss WHT regulatory framework contains a definition of a «bond for Swiss WHT purposes» which is broader than the definition of a bond under the Swiss prospectus rules (see Section C.2 above).

[Rz 56] The concept of a «bond for Swiss WHT purposes» encompasses (i) every «collective raising of funds» (ii) with the issuance of written recognitions of debt by the debtor. According to the practice of the SFTA³³, it is considered that a collective raising of funds takes place as soon as a legal entity borrows from:

- more than 10 non-banking lenders under similar conditions (same interest rate, same duration but not necessarily same par amount); or
- more than 20 non-banking lenders under variable conditions.

[Rz 57] The concept of «non-banking lenders» is identical to the one set out under Subsection a) above. Only institutions which benefit from a banking license and which are conducting actual banking activities are excluded

[Rz 58] As mentioned above, the tax definition of a «bond for Swiss WHT purposes» can be triggered when a borrower is financed by more than 20 distinct lenders under variable conditions. Accordingly, this threshold can be met through several financial relationships arising over time in the course of separate transactions. The SFTA has therefore adopted a practice³⁴ according to which the threshold of 20 is to be analysed within specific categories of lendings (baskets), whereby 20 distinct creditors are allowed within each basket. Examples of such baskets are, for example, (i) lendings over one year, (ii) lendings under one year, (iii) current accounts and (iv) guaranteed deposits.

[Rz 59] An additional aspect to be taken into account relates to the assignability. As mentioned above, one prong of the tax definition of a «bond for Swiss WHT purposes» is the requirement of a written recognition of debt on the part of the debtor. In its practice³⁵, the SFTA has considered that if a loan agreement provides for the possibility to assign tranches of the loan, the tax definition of a «bond for Swiss WHT purposes» can be triggered as a result of partial assignments (which lead to an increase in the number of creditors under the loan). In order to cover this point, it is important that the contractual documentation of the SIB contains a clause prohibiting the investors to assign tranches of the SIB if such assignments result in the existence of more than 10 non-banking lenders (if the assignments take place under the initial financing conditions) or, more generally, of more than 20 non-banking lenders.

c) Conclusion

[Rz 60] In light of the above, the Swiss WHT implications must be carefully assessed prior to the launch of the SIB project.

³³ See Article 15 (1) of the Swiss WHT Ordinance and SFTA Guideline S-02.122.1 (4.99) in relation to bonds.

³⁴ Regarding this practice of the SFTA, see in particular MARCO DUSS / ANDREAS HELBING / FABIAN DUSS, in: Martin Zweifel / Michael Beusch / Maja Bauer-Balmelli (Ed.), Bundesgesetz über die Verrechnungssteuer, Basel 2012, N 33a *ad* Art. 4.

³⁵ SFTA Guideline S-02.122.1 (4.99) in relation to bonds, para. 3 c) and SFTA Guideline S-02.128 (1.2000) in relation to syndicated credit facilities, para. 4.

- If the issuer intends to remain outside the scope of the Swiss WHT regulations, it is critical to monitor the number of non-banking lenders, both at the outset and during the life of the project, and to draft the contractual documentation of the SIB in such a way as to ensure that partial assignments may not trigger Swiss WHT implications, respectively that the relevant investor indemnifies the issuer against adverse consequences flowing from the application of the Swiss WHT rules.
- Should the issuer decide that, in light of the nature of the SIB project and the number of investors, the payments to be made under the SIB will be subject to the Swiss WHT, the issuer needs to put in place the infrastructure ensuring that the Swiss WHT is levied and paid to the SFTA and that the investors are provided with the necessary documentation to claim reimbursement of the Swiss WHT, as the case may be.

2. Swiss stamp tax

[Rz 61] The Swiss issuance stamp tax (*droit de timbre d'émission / Emissionsabgabe*) only applies to certain types of «participation rights» (such as shares) issued by Swiss legal entities (Articles 1 (1) (a) and 5 Swiss Stamp Tax Act). Generally speaking, a debt instrument such as a SIB should not fall within the ambit of the «participation rights» subject to the Swiss issuance stamp tax.

[Rz 62] The scope of the Swiss negotiation stamp tax (*droit de timbre de négociation / Umsatzabgabe*) is slightly broader and encompasses, for example, «bonds» (*obligations / Obligationen*) (Articles 1 (1) (b) and 4 (3) of the Swiss Stamp Tax Act). That being said, the reasoning made from a Swiss WHT perspective also applies in this context³⁶. Consequently, a loan which is not characterized as a «bond for Swiss WHT purposes»³⁷ would also not fall within the ambit of the Swiss negotiation stamp tax.

3. Swiss VAT

[Rz 63] As far as the treatment of the SIB from a Swiss VAT perspective at the level of the SIB issuer is concerned, one must distinguish between (a) the payments received by the SIB issuer from the outcome funders and (b) the payments made by the SIB issuer to the social investors.

a) Payments received by the SIB issuer from the outcome funders

[Rz 64] The funds received from an outcome funder which is a State entity may be characterized as a «subsidy» (*subvention / Subvention*), which is not subject to Swiss VAT (Article 18 (2) (a) Swiss VAT Act), *but* which also proportionately reduces the right of input tax deduction³⁸. In other words, the payment made by the outcome funder may not be used to offset against the VAT levied on payments made by the Swiss-based SIB issuer. If the SIB issuer benefits from a Swiss VAT exemption on payments³⁹ (which might be one of the tax exemptions granted to a SIB issuer

³⁶ See SFTA Guideline S-02.122.1 (4.99) in relation to bonds.

³⁷ See the tests described under Section D.1.b) above.

³⁸ Article 33 (2) Swiss VAT Act.

³⁹ See Article 107 (1) (a) Swiss VAT Act and Articles 143 *et seq.* of the Swiss VAT Ordinance.

if it enjoys a special status in Switzerland, notably under the Swiss Host State Act (*Loi sur l'Etat hôte / Gaststaatgesetz*), typically formalized in a so-called headquarters agreement), the lack of offset possibility is only of limited relevance. In such a situation, the SIB issuer is indeed not charged any Swiss VAT by third parties providing services/products to the issuer and, thus, the impossibility to «deduct» the VAT is not relevant for the SIB issuer.

[Rz 65] The funds received from the outcome funder which are private entities constitute a «gift» (*donation / Geschenk*), which is also not subject to Swiss VAT (Article 18 (2) (d) Swiss VAT Act). These funds do not result in a reduction of the input tax deduction⁴⁰

b) Payments made by the SIB issuer to the social investors

[Rz 66] The second relationship arising in the context of a SIB is the one between the SIB issuer and the social investor. Such relationship would in all likelihood be characterized as a «loan» from a Swiss VAT perspective. The SIB issuer is the borrower under such loan and no Swiss VAT arises for the SIB issuer in this context.

4. Tax implications for Swiss-resident investors

[Rz 67] The Swiss tax implications for the Swiss-resident investors in a SIB will primarily depend upon whether or not the SIB is held in the private wealth of the Swiss-resident investor. In a nutshell, the following distinctions can be made:

- If the SIB is held in the private wealth (*fortune privée / Privatvermögen*) of the Swiss-resident investor, any return exceeding such investor's investment into the SIB will be characterized as taxable income. In the event of a loss, no tax deduction shall be granted to the investor. In particular, the shortfall will in all likelihood not be characterized as a «gift» as there is no intent to give on the part of the investor.
- If the SIB is held as a business asset (*fortune commerciale / Geschäftsvermögen*), a positive return realized by the investor will also constitute taxable income. By contrast, a loss realized by the investor should be characterized as tax deductible, as it should amount to a commercially justified expense.

[Rz 68] The tax treatment of the SIB investment for investors resident in jurisdictions other than Switzerland will depend upon the rules applicable in each jurisdiction.

E. Practical considerations drawn from the Program for Humanitarian Impact Investment (PHII)

1. Presentation of the PHII

[Rz 69] On 6 September 2017, the ICRC launched the Program for Humanitarian Impact Investment (the «PHII»)⁴¹. The capital raised through the PHII (CHF 26 million) will be used to

⁴⁰ Article 33 (i) Swiss VAT Act.

⁴¹ For additional information, see: <https://www.icrc.org/en/document/worlds-first-humanitarian-impact-bond-launched-transform-financing-aid-conflict-hit> and MAXIMILIAN MARTIN, *The Next Phase of Innovative Financing*,

build and run three new physical rehabilitation centres in Africa (Nigeria, Mali and Democratic Republic of Congo) over a five year period. The main terms of the PHII can be summarized as follows:

- Each social investor makes funds available to the ICRC for a five year period.
- The return on investment for each social investor is contingent upon the «efficiency» of the ICRC in the delivery of prosthetics to beneficiaries in the three physical rehabilitation centres mentioned at the outset.
- The «efficiency» of the ICRC will be determined by (i) computing the ratio of how many people receive mobility devices by physical rehabilitation professionals and (ii) comparing this figure with existing comparable physical rehabilitation centres run by the ICRC. The «efficiency» of the ICRC will be verified by a third party auditor.
- If the «efficiency» is above the benchmark, the social investor will receive its initial investment plus an annual return. If the performance of the new centers is, however, below the benchmark, then the social investor will lose a certain amount of the initial investment. In a nutshell: the higher the efficiency of the ICRC, the higher the return for the social investor.
- The funds for the repayment of the social investors are provided to the ICRC by so-called outcome funders. At the end of the 5th year, the outcome funders – Belgium, Switzerland, Italy, the UK and a private Spanish foundation («la Caixa») – will pay the ICRC according to the results achieved. These funds will in turn be used to pay back the social investors (i) partially, (ii) in full or (iii) with an additional return, depending on how the ICRC's «efficiency» in running the three physical rehabilitation centres mentioned at the outset.

2. Lessons learned

[Rz 70] As mentioned under Section A. above, the PHII is the first SIB project in the humanitarian field. The following elements were key factors in ensuring a timely launch of this project and may also serve as guidelines for future similar projects:

- *Internal team / external advisors*: it is of paramount importance to assemble a team of internal at the outset of the project and external advisors and to allocate responsibility, particularly regarding to the following work streams: (i) design of the mechanics of the SIB, (ii) handling of the distribution process (private investors), (iii) discussions with public bodies (outcome funders) and (iv) legal and tax implications of the SIB.
- *Contractual documentation*: the SIB is composed of a web of contractual relationships. The two most important contractual relationships are those (i) between the SIB issuer and the social investors and (ii) between the SIB issuer and the outcome funder. To all extent possible, these two contractual relationships should be standardized by drafting a «template contract» for each of them at the outset of the project. The specificities of each contracting party (which may in particular be the case as far as the outcome funders are concerned) should be addressed in an *addendum* which amends specific provisions of the «template contract». Ensuring an equal treatment among all social investors and among all outcome funders can be a challenging task. The negotiation of the contractual documents, their readability and their

2 October 2017, available at: https://ssir.org/articles/entry/the_next_phase_of_innovative_financing. The authors of this contribution have been involved in the launch of the PHII.

comparability is greatly enhanced if the SIB issuer proposes a «template contract» which may only be amended by way of an *addendum*.

- *Distribution*: The target markets for the distribution of the SIB (in particular the places of residence of the possible social investors which may be approached) should be clarified as early as possible in the process, so as to ensure that any specific requirements (for example as far as «investor-protection» rules are ensured) can be taken into account in the course of the preparation of the documentation governing the SIB project. Likewise, the number of possible investors *being approached* (as opposed to the number of investors *actually subscribing*) will be one of the elements to determine whether a prospectus is to be prepared in respect of the SIB⁴².
- *Taxation of the SIB*: It is important to examine the taxation of the SIB, primarily at the level of the issuer (taking into account possible tax exemptions which may have been granted to the issuer), but also at the levels of the social investors and the outcome funders. From a Swiss tax perspective, the implications of the Swiss WHT⁴³ must be well understood, as they have an impact on the number of investors that can subscribe the SIB. In Switzerland, it is common practice to seek a ruling from the SFTA to obtain legal certainty as to the tax treatment of a specific project.

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⁴² See Section C. above.

⁴³ See Section D.1. above.