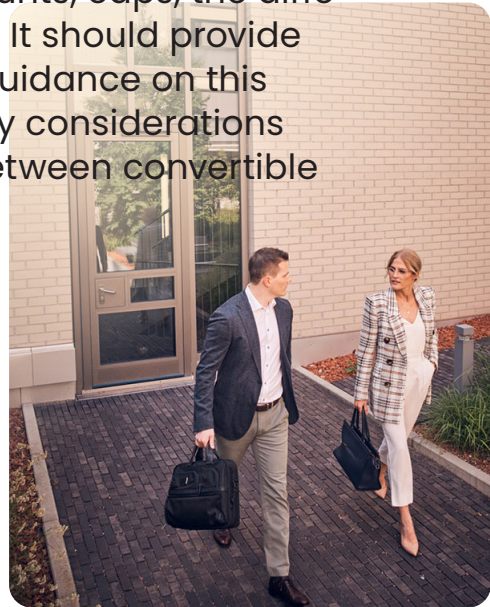




# CONVERTIBLE LOAN AGREEMENTS – LEGAL AND TAX INSIGHTS TO GET IT RIGHT FROM THE START

Convertible loans have long been a flexible and popular tool for investing in early-stage companies (start-ups). In this article, we explore how convertible loans work, highlight their advantages and disadvantages compared to equity financing, and address important considerations prior to executing a convertible loan agreement. We will clarify the complexities surrounding some of the key elements of convertible loan agreements, such as discounts, caps, the different conversion events and tax considerations. It should provide founders and investors with straight-forward guidance on this financing instrument by briefly outlining the key considerations to make informed decisions when choosing between convertible loans and equity financing.



### 1. What is a Convertible Loan?

A convertible loan is a financing instrument designed to quickly secure cash without the complexities of an equity financing round. An investor lends money to a start-up with the right (voluntary conversion) or obligation (mandatory conversion) to convert the loan into shares in the company if and when a conversion event occurs. The determination of whether the conversion is considered a right (voluntary conversion) or an obligation (mandatory conversion) from the investor's standpoint, as well as the identification of the corresponding conversion events, are stipulated in the convertible loan agreement and are subject to negotiation. A conversion event can be a defined maturity date, the occurrence of the next (qualified) equity financing round or an exit transaction.

### 2. What Is the Incentive for a Start-Up to Enter into a Convertible Loan Agreement with an Investor?

Equity financing is the prevailing investment choice for start-ups to obtain funds. For early-stage start-ups, determining the company's reasonable valuation is often a challenge. Early-stage start-ups often do not have paying customers, market traction, profits, or even revenue yet. This makes it difficult (if not impossible) to come up with a reasonable or fitting valuation of the company.

In the absence of a clear valuation, founders may agree on low valuations and thus accept a high dilution of their shareholdings in the company. The same can of course apply to investors in case the valuation is unreasonably high. Thus, choosing a convertible loan is advantageous if the start-up aims to delay detailed valuation discussions. It is still paramount that the start-up and the investor agree on specific conversion terms, which in most cases refer to the next (qualified) financing round, exit transaction and the maturity date of the loan.

In addition, convertible loans have proven helpful when there is not enough time for an equity financing round and/or when a start-up only needs to raise a small amount, e.g. to bridge a few months of liquidity between equity financing rounds.

In conclusion, the primary incentives for start-ups (and investors) to enter into convertible loan agreements lie mainly in the avoidance of extensive negotiations and valuation discussions between the start-up and the investors as well as

ensuring quick access to funds, which will be converted into equity in the near future.

### 3. Key Legal Terms in Convertible Loan Agreements

Convertible loan agreements are governed by precise legal and tax provisions that dictate the functionality of this financing tool. When entering into negotiations of a convertible loan agreement, it is crucial for both investors and start-ups to be familiar with the relevant terminology and to understand the consequences of certain terms and conditions.

#### 3.1 Loan Amount and Interest Rate

The loan amount represents the funds granted to the start-up by the investor. The loan amount can vary greatly, typically between 25'000 and a few million Swiss Francs. Convertible loans often carry an interest rate. It is important to note that the interest due is often not paid in cash. Instead, it is converted into equity together with the outstanding loan amount upon the occurrence of certain conversion events.

#### 3.2 Subordination

As a debt instrument, convertible loans will appear on the start-up's balance sheet as a (long-term) debt position. When a start-up's balance sheet indicates over-indebtedness (*Überschuldung*), the start-up is in need of a subordination (*Rangrücktritt*) from the lenders to prevent having to declare bankruptcy. A subordination clause in a convertible loan agreement is therefore a must for most start-ups.

The subordination clause stipulates that the lenders agree to subordinate their claims to all existing and future lenders. If subordinated, (convertible) loans are treated economically as equity, i.e. the lenders agree to be paid, in the worst-case scenario of bankruptcy, in the same priority as the

shareholders. Lenders often understand this request and accept this in exchange for the potential upside of converting their debt into equity.

### 3.3 Conversion / Trigger Events

The convertible loan agreement typically defines certain events that trigger a (voluntary or mandatory) conversion of the loan into shares of the start-up.

Convertible loans usually have a maximum duration, known as the maturity date. The maturity date is the date on which the loan is due. It is the point in time when the company must repay the loan (and accrued interest thereon, if any) if the loan has not been converted into equity by that time. Common maturity dates range from nine to 36 months after the execution of the convertible loan agreement. In the absence of any earlier conversion events and in case of a mandatory convertible loan, conversion must take place within a specified period once the maturity date is reached (instead of the repayment by the start-up). The conditions for such a conversion at the maturity date are typically predetermined in the convertible loan agreement (e.g. the valuation basis).

In addition to the maturity date, the conversion of a convertible loan occurs in most cases during an equity financing round. To safeguard the lender's interests, it is sometimes agreed that the next financing round must exceed a certain investment threshold (so-called qualified financing round). Therefore, upon a share capital increase in accordance with the (qualified) financing round, any outstanding convertible loans will convert simultaneously into shares in accordance with the terms and conditions provided in the convertible loan agreement.

The two aforementioned triggering events are the most common conversion events. However, there are some additional possibilities to consider, including exit transactions and the achievement of specific milestones.

The conversion of loans into shares involves a subscription by way of set-off. It is important to note that, depending on the method of the loan conversion, it may be necessary to disclose the lenders in the articles of association of the start-up. Therefore, it is highly recommended that both the start-up and the investors discuss the details of the conversion mechanism prior to an upcoming capital increase.

### 3.4 Valuation Cap, Valuation Floor and Discount Rate

The valuation cap provides for a maximum limit on the valuation of the start-up, while the valuation floor ensures there is a minimum valuation stipulated in the convertible loan agreement. Both have an impact on the share (or conversion) price at which the convertible loan converts into equity at the occurrence of a conversion event. Understandably, the valuation cap is in the interest of the investors and provides for a capped share price. The valuation floor on the other hand is in the interest of the start-up and provides for a minimum share price.

The discount rate is applied to the share price paid in the upcoming financing round by the investors of the respective financing round; the same logic can be applied if an exit transaction is the conversion event. Discounts are provided as a percentage of the respective share price and typically range from 0% to 20%.

The valuation cap, valuation floor and discounts are important parameters for the investor and the start-up. They can be combined and should be carefully discussed.

If an investor commits to a convertible loan agreement without a maximum valuation cap and contributes to the value growth of the start-up, the upcoming financing round is likely to command a higher valuation and thus a higher share price for

the investor when converting their convertible loan. This is why many investors will want to agree on a maximum valuation cap for the conversion of their loan.

Investing in early-stage start-ups is inherently risky. By offering a discount on the conversion price, investors are compensated for the higher risk they are taking by providing capital to the company at an earlier stage of development. The discount on the share price paid by future investors during a financing round provides previous investors with a financial advantage over future investors and thus recognizes the risks that early investors take in this regard. Depending on the stage of the start-up and the respective risk profile, the start-up often agrees on varying discounts with the investor depending on the current risk profile of the start-up.

## 4. Tax Considerations

### 4.1 Qualification as a Bond for Swiss Withholding Tax Purposes

A loan qualifying as a bond within the meaning of the Swiss withholding tax practices is subject to withholding, whereby the term "bond" is defined broadly. In general, a bond – subject to Swiss withholding tax – is a debit instrument issued multiple times with same or similar terms for the purpose of the collective procurement of debt. A bond exists for Swiss withholding tax purposes whenever a loan is structured as a bond, a medium-term note or the 10/20 non-bank rule is satisfied:

- 10 non-bank rule: This rule is satisfied if a domestic borrower receives loans from more than 10 non-bank lenders (i.e. the number of lenders is decisive and not the number of loans) in return for the issuance of debt certificates at *identical* conditions and the total loan amounts to at least CHF 500'000. The term "identical conditions" is defined narrowly (i.e. in particular with regard to the interest rate, duration and repayment condition).
- 20 non-bank rule: This rule is satisfied if a domestic borrower receives loans on a continuous basis from more than 20 non-bank lenders (i.e. the number of lenders is decisive and not the number of loans) in return for the issuance of debt at variable conditions and the total loan amounts to at least CHF 500'000. Within the 20 non-bank rule, any sort of debt has to be considered, except intragroup loans, current account payables and non-financial liabilities.

In addition to the aforementioned rules, the loans must be allocated to one of the following baskets ("basket-allocation"): i) short-term liabilities (duration less than 12 months), ii) long-term liabilities (duration more than 12 months), iii) guarantees / security deposit funds or iv) current account payables. Only if the number of lenders in one of these baskets exceed the 10/20 rule do the loans in the respective basket qualify as a bond and trigger Swiss withholding tax implications. Moreover, each lender is only considered once.

### 4.2 Swiss Withholding Tax Implications

As long as the 10/20 non-bank rule is not satisfied and loans do not qualify as a bond, Swiss withholding tax is not triggered, provided that the interest yields are at arm's length and the thin capitalization rules ("hidden equity") are met. Aside from the qualification as a bond, interest payments can also be subject to Swiss withholding tax in the light of a "bene-

fit in kind". This is in particular the case if the interest rate is not at arm's length (safe harbour interest rates published annually by the Swiss Federal Tax Administration)<sup>1</sup>.

If the loans qualify as a bond, the borrower has to register with the Swiss Federal Tax Administration, declare and pay the Swiss withholding tax of 35% on the interest and on any discount at the conversion of the convertible loan into shares. According to the Swiss Withholding Tax Act, the Swiss withholding tax must be charged to the lenders. Therefore, the borrower is required to deduct the Swiss withholding tax from the interest payment. A conversion discount is considered the same as such an interest payment and therefore is subject to Swiss withholding tax. In case Swiss withholding tax is not charged to the lender, the Swiss withholding tax is grossed up (effective Swiss withholding tax rate of 53.8%).

A lender residing in Switzerland is entitled to a full refund of the Swiss withholding tax if the (gross) income is duly declared on the tax return or duly recognized in the financial statements. A lender domiciled abroad can only (partially) claim back the Swiss withholding tax based on a double tax treaty.

In terms of start-up financing, the borrower often does not have the necessary liquidity to pay the Swiss withholding tax. In practice, the lender therefore pays the Swiss withholding tax to the Federal Tax Administration on behalf of the borrower.

## 5. Income Tax Considerations

For individual lenders, interest payments and any discount at the conversion of the convertible loan into shares are subject to income tax. For corporate lenders, the entire income or capital gain is subject to corporate income tax. This general rule is applicable for convertible loans if certain exemptions are not applicable (see section 6).

## 6. Exemptions: Classic Convertible Loan or Transparent Convertible Loan

Exemptions to the aforementioned tax implications are applicable if the convertible loan qualifies either as "classic convertible loan" or as "transparent convertible loan".

A conversion discount of a classic convertible loan is not subject to income and Swiss withholding tax. The conditions for qualification as a classic convertible loan are:

- Swiss issuer of the convertible loan;
- Conversion right entitles the lender to subscribe newly created shares of the issuer (e.g. no transfer of treasury shares);
- Issuance at par or at a premium;
- Repayment at par;
- Conversion discount of maximum 20%.

A mandatory conversion should not prevent a convertible loan from being considered a classic convertible loan. However, according to current tax practice, the Swiss Federal Tax Administration recommends an advance tax ruling in order to ensure the qualification as classic convertible loan.

### Example classic convertible loan

Duration	5 years
Currency	CHF
Issue price	100%
Repayment	100%
Coupon	5%
Conversion Right	20% discount compared to the price of the last financing round

- › 5% coupon is subject to income tax;
- › If the 10/20 non-bank rule is not satisfied, the 5% coupon is not subject to Swiss withholding tax
- › 20% discount is tax-free (no Swiss withholding and no income tax)

### Example non-transparent convertible loan

Duration	2 years
Currency	CHF
Issue price	100%
Repayment	100%
Coupon	5%
Conversion Right	20% discount compared to the price of the last financing round

- › The 5% coupon and the 25% discount are subject to income tax;
- › If the 10/20 non-bank rule is satisfied, the 5% coupon and the 25% discount are also subject to Swiss withholding tax. The borrower has to withhold Swiss withholding tax from the lenders and pay it to the Swiss Federal Tax Administration.

To summarize, a classic convertible loan can avoid the tax consequences in connection with a conversion discount, even if the 10/20 non-bank rule is satisfied.

Another exemption applies if the convertible loan is transparent. For qualification as a transparent convertible loan, the underlying components (i.e. option / conversion right and bond) must be separated. In practice, the different components must be disclosed separately in the term sheet / loan agreement. If the loan qualifies as a transparent convertible loan, the conversion discount is subject neither to income tax nor to Swiss withholding tax even if the 10/20 non-bank rule is satisfied. However, given that for start-ups comparative information is generally unavailable, the underlying components of the bond cannot be determined. Therefore, the transparent convertible loan exemption is usually not applicable for start-ups.

<sup>1</sup> In addition, if the borrower shows hidden equity, interest payments on loans from related parties (or guaranteed by related parties) a benefit in kind, subject to Swiss withholding tax, can result.

### Keyfacts

- 01 A convertible loan combines the main benefits of a loan in terms of speed and reduced complexity with those of an equity investment.
- 02 Convertible loan agreements offer start-ups a flexible and strategic financing option, providing quick access to capital, deferred valuation discussions, and the possibility for investor participation in company growth. Nonetheless, careful examination of the applicable terms is essential for both start-ups and investors. As straightforward or "market standard" as it may sound, convertible loan agreements can quickly be poorly structured and misunderstood. The above-mentioned key points must therefore be carefully considered prior to executing a convertible loan agreement. Both the start-up and the investor are thus well advised to obtain the necessary information from the beginning.
- 03 When convertible loans are issued, tax implications should be considered. With a classic convertible loan, no tax implications on the conversion discount are triggered. Moreover, to avoid Swiss withholding tax implications under the 10/20 non-bank rule, the number of loans should always be monitored.



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