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FStaxworld
Your November snapshot

In this month's FS*taxworld*, we analyze the Swiss Federal Supreme Court denial of withholding tax refunds in connection with derivative transactions

The View from Deloitte

Dear Reader,

The Federal Supreme Court passed on 5 May 2015 two sentences (2C_364/2012;2C_377/2012 and 2C_895/2012) regarding the refund of Swiss withholding tax in connection with total return swap and futures transactions. On 28 October 2015 the written reasoning of the decisions was published. In both cases the entitlement for refund of Swiss withholding tax under the double tax treaty between Switzerland and Denmark was denied due to a lack of beneficial ownership in the dividends received from Swiss equities acquired for hedging purposes.

Leading case with respect to total return swaps (2C_364/2012;2C_377/2012)

Facts and circumstances

A Danish bank entered into total return swaps on equity baskets involving Swiss equities. In order to hedge the swap positions the bank acquired the corresponding amount of the underlying Swiss equities.

The Danish bank filed reclaim requests for dividends on the acquired Swiss equities due during the life of the swaps based on the applicable double tax treaty between Switzerland and Denmark. However, the refund was denied by the Federal Tax Administration, arguing that the bank was obliged by the swap agreement to forward the dividends to third parties and the bank is, therefore, not the beneficial owner of the dividends.

Considerations of the Federal Supreme Court

In its written decision the Federal Supreme Court confirmed that the dividend recipient is the beneficial owner in case it has the decision power with respect to the utilization of the dividend. No beneficial ownership is given in case this decision power is limited because the recipient is legally or de facto obliged to forward the dividend to a third party. The decision power is limited in case the following conditions are cumulatively met (concept of double interdependency):

1. The realization of the dividend income is linked to the forwarding to the income, i.e. the dividend income would not have been realized without the obligation to forward the income; and
2. The forwarding of the income is linked to the realization of the dividend income, i.e. there would be no obligation to forward income in case no dividend income is realized.

In addition, a forwarding of dividend income does not limit beneficial ownership in case it is just a later utilization of the income without a causal link to the realization of the dividend income.

Further, the fact that 100% of the received dividend is forwarded is an argument against beneficial ownership of the dividend recipient. However, beneficial ownership is not automatically given in case a small portion of the dividend remains at the recipient of the original dividend, e.g. as compensation for the later forwarding.

In the case at hand the Danish bank fully hedged its total return swap position simultaneously and without exception and the interest received on the total return swap (LIBOR + margin) allowed the bank to finance the acquisition of the underlying Swiss equities and realize the dividend income. Further, according to the specific swap agreements the bank did not assume any significant risks in the transaction. The assumed credit risk, i.e. the risk that the counterparty would not fulfil its obligations, was by far compensated by the margin received. Without the assumption of significant risks in the transaction, the bank’s obligation to forward income was limited to the dividend income that was actually received.

Based on the above the Federal Supreme Court concluded that both interdependencies were fulfilled and finally denied the withholding tax refunds due to a lack of beneficial ownership.

Furthermore, the Federal Supreme Court ruled that already refunded Swiss withholding taxes in connection with the total return swap arrangement at hand could be qualified as an unjustified enrichment and in such case must be reimbursed. The applicable statute of limitation would be three years. In the case at hand the Federal Supreme Court repelled the question whether processed refunds must be reimbursed for further investigations to the Federal Tax Administration.

Finally, the Federal Supreme Court explicitly stated that this decision does not mean that all Swiss withholding tax refunds in connection with total return swaps will be denied as every transaction must be reviewed based on the specific circumstances. In particular the decision at hand only treated short-term, fully hedged total return swap arrangements with Swiss equities where the dividend recipient did not assume any significant risks in the transaction.

Second case with respect to SMI Futures (2C_895/2012)

Facts and circumstances

A Danish bank sold SMI Futures and purchased the underlying Swiss equities to hedge the position. In order to exit the position at the expiration, the bank repurchased the futures contracts and sold the equities that served as hedge. The futures and equities were traded via different brokers.

The Danish bank filed reclaim requests for dividends on the acquired Swiss equities due during the life of the SMI Futures based on the applicable double tax treaty between Switzerland and Denmark. The Federal Tax Administration denied the refund, arguing that only a small portion of dividends remained as profit at the bank and the bank is, therefore, not the beneficial owner of the dividends.

Considerations of the Federal Supreme Court

In its written decision the Federal Supreme Court referred to the leading case with respect to the application of the double tax treaty and the definition of beneficial ownership.

In the case at hand the Danish bank retained from the futures transactions an amount equal to approx. 6.6% and 9.0% of the total dividend income and equal to 0.04% and 0.08% of the transaction volume. The Federal Supreme Court ruled that the fact that a small portion of the dividend income remained at the bank does itself not exclude a harmful dividend forwarding.

Further, the acquisition of the Swiss equities were fully debt financed by the Swedish parent company of the bank and the bank refused to disclose the financing costs violating its obligations to co-operate. Based on this fact and on indicia presented by the Federal Tax Administration the Federal Supreme Court concluded that the bank forwarded a portion of the dividends received in form of interest payments to its Swedish parent company.

In addition, the Federal Supreme Court concluded that the bank held the underlying equities only for a very short period of time and then sold it back to the original seller as part of the transaction scheme it has created. As a result, the largest part of the dividends received were forwarded to persons resident outside of Denmark via the pricing of the equity transactions.

Furthermore, the bank refused to disclose the identity of the counterparties behind the brokers and the agreed risk allocation of the whole transaction. As the bank only retained a very small income portion (0.04% and 0.08% of the transaction volume) the Federal Supreme Court concluded that the bank did not assume any significant risks and therefore was only obliged to forward dividend income that was actually received.

Based on the above the Federal Supreme Court concluded that both interdependencies were fulfilled and finally denied the withholding tax refunds due to a lack of beneficial ownership.

Also in this case the Federal Supreme Court ruled that already refunded Swiss withholding taxes in connection with the transaction scheme at hand could be qualified as an unjustified enrichment and in such case must be reimbursed. The applicable statute of limitation would be three years. In the case at hand the Federal Supreme Court repelled the question whether processed refunds must be reimbursed for further investigations to the Federal Tax Administration.

Impact of the decisions to the financial market

The Federal Supreme Court denied the withholding tax refund based on a lack of beneficial ownership and not based on anti-avoidance rules. Thereby, the question whether the transaction effectively lead to tax savings and the argumentation of economical (non-tax) reasons faded into the background.

However, the above decisions do clearly not lead to a denial of beneficial ownership for all transactions involving derivative instruments such as total return swaps. Nevertheless, the Federal Tax Administration will based on these decisions further deny Swiss withholding tax refunds on Swiss dividend and interest payments in cases with similar characteristics such as:

- Full hedge of the derivative transaction;
- No assumption of any significant risks by the claimant in the transaction;
- Fully debt financed acquisition of the underlying Swiss equities.

Furthermore, in case the beneficial ownership is denied to the dividend recipient the Federal Supreme Court left it open if the beneficial ownership would then be with the swap counterparty and if this person would be entitled to reclaim withholding taxes based on the applicable double tax treaty.

We recommend to carefully review Swiss withholding tax reclaims in connection with derivative instruments against the concept of double interdependency and if necessary discuss the acceptable conditions and the entitlement to reclaim withholding tax in advance with the Federal Tax Administration.

Finally, financial institutions will have to review and potentially amend its business model on total return swaps and similar arrangements to meet the Swiss withholding tax requirements and thereby consider potential conflicts with other regulations, which may limit their proprietary trading ability. As a consequence, entering into such transactions might in future be less profitable for the counterparty due to the additional withholding tax burden.

Our Deloitte tax specialists are available in case you are interested in further conversations or support with regard to pending cases or structuring needs.

Regards,

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André Kuhn

Report from the FATCA Frontline: Senate Committee Advances Ratification of Swiss-U.S. Tax Treaty

Before the U.S. may issue a single group administrative request to the Swiss tax authorities pursuant to the Swiss Model 2 IGA, a pivotal tool from a U.S. perspective for monitoring compliance by Swiss financial institutions with FATCA, the U.S. must first ratify the revisions to the Double Taxation Treaty (DTT) with Switzerland. However, for the past few years, a single Republican Senator and now Presidential candidate, Rand Paul of Kentucky, invoked a Senatorial procedural device to prevent a Senate vote on ratification despite strong business support in its favor (please see previous coverage of this topic in the FStaxworld here). On 10

November though, the U.S. Senate Foreign Relations Committee advanced the ratification process materially, by approving eight long-awaited international tax treaties, including the Swiss one.

Despite such progress, the process towards final ratification of the revised DTT remains uncertain and is unlikely to be swift, as the following obstacles remain before the treaty comes into force:

- The Foreign Relations Committee must report on the treaty and send it out of committee for consideration by the full Senate;
- The full Senate must ratify the treaty by a two-thirds majority vote;
- The President must sign the treaty to complete the treaty approval process in the United States; and
- The formal instruments must be exchanged with Switzerland.

Nonetheless, the likelihood of a ratified treaty and consequent anticipation of group administrative requests pursuant to the terms of the Swiss IGA draw nearer.

For more information, please contact **Paul Millen**.

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