Swiss Supreme Court rules on treaty beneficial ownership in connection with derivative transactions

Switzerland’s Federal Supreme Court issued two important decisions on 5 May 2015 regarding the concept of beneficial ownership of income under tax treaties, as it applies to total return swaps and futures contracts.

A total return swap is a financial contract in which the parties agree to exchange the return (dividends and price changes) of an underlying asset or a basket of underlying assets for a set rate. In such an arrangement, the party receiving the total return will receive income generated by the asset, as well as the benefit if the price of the asset increases over the life of the swap. In return, the recipient must pay to the counterparty the set rate over the life of the swap. If the price of the asset drops over the life of the swap, the total return recipient will be required to pay the counterparty the amount by which the asset has dropped in price.

A futures contract is a financial contract between two parties to buy an underlying asset or a basket of underlying assets at a predetermined price, with settlement occurring in the future. For Swiss market index (SMI) futures, the underlying assets are the shares representing the SMI. SMI futures are traded on the EUREX stock exchange.

The cases involved two Danish banks that had fully hedged Swiss equities positions and claimed refunds of Swiss withholding tax on dividends received. The Federal Tax Administration (FTA) denied the refunds on the grounds that the conclusion of these derivative transactions resulted in the loss of beneficial ownership of dividends received from Swiss shares acquired for hedging purposes. The banks appealed to the Federal Administrative Court, which ruled against the FTA. The FTA appealed, and the Federal Supreme Court reversed the decisions of the Federal Administrative Court and upheld the position of the FTA.

Total return swap case

In 2007, a Danish bank entered into total return swap agreements with several counterparties; the underlying assets for the agreements were shares in Swiss companies. On the basis of the swap agreements, the bank was required to pay the counterparties an amount equal to the returns generated during the life of the swaps (i.e. dividends) and the bank received fixed interest based on LIBOR, as well as an additional margin.

To hedge the swap positions, the bank purchased the corresponding number of the underlying Swiss shares of the total return swap. Dividends were paid on the shares and a 35% Swiss withholding tax was levied. The Danish bank claimed a full refund of the withholding tax, based on the Switzerland-Denmark tax treaty in effect at the time. The treaty did not contain a beneficial ownership clause in the dividends article or an anti-abuse provision.

The FTA denied the refund on the grounds that the bank was not the beneficial owner of the dividends because it had entered into the total return swap agreements and was de facto obliged to forward the Swiss dividends received to the swap counterparties. The bank appealed to the Federal Administrative Court, which concluded in 2012 that, even though the bank entered into the swap transactions, it retained beneficial ownership of the dividends; therefore, the court granted a full refund of the withholding tax.
In its decision, the Federal Supreme Court confirmed that the beneficial owner concept is implicit in all tax treaties, i.e. a recipient of dividend income must be the beneficial owner to claim treaty benefits, even if the relevant treaty does not contain a specific reference to beneficial ownership.

Beneficial ownership requires that a dividend recipient have certain rights and authority with respect to the use and disposition of the dividends received; these rights are limited if the recipient is legally or de facto obliged to pass on the dividends to a third party. A further indication of beneficial ownership is the assumption of the dividend risk, i.e. the beneficial owner should be the party that bears the risk that no dividend will be distributed.

The Federal Supreme Court concluded that the Danish bank was obligated to forward the dividends to the counterparties, that this obligation was inextricably linked to the dividend distributions on the underlying shares and that the bank did not assume any risk in the transaction and, consequently, could not be considered the beneficial owner of the dividends.

**SMI futures case**

A Danish bank sold SMI futures and purchased the underlying Swiss shares to hedge the position. To exit its position when the futures contracts were about to expire, the bank repurchased the contracts and sold the shares that served as a hedge. The futures and shares were traded via different brokers. Over the life of the SMI futures, the bank collected dividends on the acquired Swiss shares and then claimed a refund of the 35% Swiss withholding tax, based on the Switzerland-Denmark treaty.

The FTA again took the position that the bank was not the beneficial owner of the dividends and, therefore, was not entitled to treaty benefits – because of the sale of SMI futures, the bank was factually obliged to pass on the Swiss dividends received to third parties. The FTA also suspected that the buyers of the SMI futures and the sellers of the Swiss shares were identical, and that the entire transaction was prearranged with the sole purpose of benefitting from the favorable withholding tax rate under the treaty. Furthermore, the acquisition of the shares was fully debt-financed by the bank’s parent company and no evidence was presented that the interest paid was not dependent on the dividend payments received on the Swiss shares. The bank was criticized for not disclosing the financing agreement with the parent company. However, the bank appealed the FTA’s decision and the Federal Administrative Court ruled against the FTA.

The Federal Supreme Court’s opinion referred to its definition of beneficial ownership in the other Danish bank case, although the facts of the SMI futures case were more complex and not entirely clear. Nevertheless, the court held that the facts that the shares were traded in block trades and not anonymously over the stock exchange, and that the counterparties behind the brokers were not disclosed, indicated that the transactions were prearranged. Further, the bank fully hedged the position and did not bear any risk. As such, the economic (i.e. nontax) reason for the brokers and the bank to conclude the transactions was not apparent. Finally, the nondisclosure of the financing arrangement was considered indicative of a potential harmful interdependence between the dividends received and the interest paid by the bank. The court held that the FTA was correct in denying the withholding tax refund.
Impact of the decisions on the financial market

During the time these cases have been proceeding through the judicial system, the FTA has denied or suspended numerous similar refunds of Swiss withholding tax in cases involving derivatives. It is important to note that the Federal Supreme Court decisions are not directly applicable to other cases – each case must be analyzed on its own merits, so different outcomes are possible.

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