

Update

Newsflash May 2015

Total Return Swap Case

Withholding Tax, Total Return Swap and other Derivatives – Swiss Supreme Court rules in favour of Swiss Tax Authorities.

On 5 May 2015, during public deliberations regarding two cases involving Danish banks, the Swiss Supreme Court set high standards for the refund of Swiss withholding tax in case of use of total return swaps with Swiss equities and other derivatives. The decision on appeal of the Swiss Supreme Court thus put an end to a three-year wait after the Swiss Federal Administrative Tribunal ruled in favour of the banks.

In other words, the Swiss Federal tax administration (“SFTA”) rightfully denied the refund of withholding tax on the banks’ declared dividend income for the main reason that the banks were not beneficial owners of the dividend income and therefore could not claim the benefit of the treaty convention.

Factual context

In the cases at hand, which are very similar, the Danish banks were involved in total return swap and futures contracts with clients. They asked the SFTA a full tax refund of withholding tax that was levied on the declared dividend income of 2006, 2007 and 2008. In 2010, their requests for refund were denied (CHF 53.5 million and CHF 26.4 million). Additionally, the SFTA asked for the restitution of the amounts already refunded in 2006 and 2007 (CHF 37.8 million and CHF 34.6 million). Both the refusal to refund withholding tax and the request for restitution of the amounts already reimbursed were based on the arguments that the banks lacked beneficial ownership and had engaged in treaty abuse.

The banks appealed the SFTA decision to the Swiss Federal Administrative Tribunal. After an analysis of the beneficial ownership requirement, the tribunal considered

that the banks remained beneficial owners of the dividend proceeds. The tribunal ruled that there was no interdependence between the dividend income and the payment obligation under the swap agreement and other derivatives contracts. The tribunal also briefly ruled on the treaty abuse argument and stated that there was no treaty abuse as the banks had sufficient substance in their country of residence.

Beneficial ownership

Under a total return swap agreement, a party to the agreement agrees to pay the full performance of a security (e.g. a share) in exchange of the promise of receiving the full performance of another asset (e.g. a bond). In this respect, the party agreeing to pay the performance of securities may classically cover its risk exposure by acquiring the underlying shares. For futures contracts, whereby a party agrees to buy from the other party a certain underlying asset, or a portfolio of underlying assets, at a predetermined price, with settlement occurring at a certain point in time in the future, the mechanism had for consequence that the bank held the shares it bought for a very short period before reselling them.

On 5 May 2015, the Swiss Supreme Court overturned the decisions of the Swiss Federal Administrative Tribunal. First of all, the Court answered the question left open by the Swiss Federal Administrative Tribunal regarding the interpretation of double tax treaties drafted and signed before 1977, which do not contain the beneficial ownership requirement. In this respect, the majority of Federal Judges stated that the beneficial ownership criterion is an implicit requirement in all “old” tax treaties. Therefore, even if the

double tax treaty Switzerland – Denmark did not contain an explicit reference to this requirement, the administration is entitled to apply this criterion.

For the Court, the relevant approach regarding the beneficial ownership requirement under tax treaties is whether the banks could freely dispose of the dividend income or if they had a legal, economical or factual obligation to transfer the income to a third party. The Supreme Court ruled in favour of an obligation to transfer and accordingly denied the beneficial ownership in particular for the following reasons:

- > The banks acted as a sort of intermediary companies which were legally, economically or factually forced to transfer the dividend income to their counterparties. The Federal Judges considered that there was hence an interrelation between the hedge and the swap;
- > Even if the banks were not obliged to transfer the dividend income itself, they had to pay amounts equal to the dividend to the counterparties;
- > The volume of futures contracts and the few parties involved;
- > The share purchase would not have been made by the banks without the swap or derivative contracts, as the remuneration obtained through those transactions was used to purchase said underlying shares.

As a consequence, the banks cannot be considered as beneficial owners and hence cannot obtain treaty relief. It should, however, be noted that there were stronger dissents by judges as regards the futures case, as the lack of documentation made it harder for the Court to conclude on a lack of beneficial ownership.

Restitution of the refund

Regarding the restitution of the amounts already refunded in 2006 and 2007, the Federal Judges debated the legal basis on which the SFTA could ask for the restitution of these amounts. The Court held that it did not yet have the information necessary to definitely rule on the case.

Consequences

By strengthening the SFTA's position in such cases, the Swiss Supreme Court judgement sends a signal for all other similar pending cases and, more generally, to the derivatives market. The Swiss Confederation emerges as an unquestionable winner and is expected to derive important benefits from these two decisions.

There were, however, strong dissents by Federal Judges supporting the argumentation of the Swiss Federal Administrative Tribunal, even if the latter's decisions were finally overruled by 4 against 1 regarding the total return swap case and 3 against 2 for the futures case. It will hence be interesting to examine the written reasonings of the Swiss Supreme Court, which may contain further guidance for the assessment of other cases. Consequently, with different fact patterns from these two cases and different tax treaties involved, the conclusions of the Court might still differ.

Please do not hesitate to contact us in case of any questions.

Your Contacts

Zurich

Pascal Hinny
pascal.hinny@lenzstaehelin.com

Heini Rüdüsühli
heini.ruedisuehli@lenzstaehelin.com

Bleicherweg 58
CH-8027 Zürich
Telephone +41 58 450 80 00
Fax +41 58 450 80 01
zurich@lenzstaehelin.com

Geneva / Lausanne

Jean-Blaise Eckert
Jean-blaise.eckert@lenzstaehelin.com

Frédéric Neukomm
frederic.neukomm@lenzstaehelin.com

Route de Chêne 30
CH-1211 Genève 17
Telephone +41 58 450 70 00
Fax +41 58 450 70 01
geneva@lenzstaehelin.com

Avenue du Tribunal-Fédéral 34
CH-1005 Lausanne
Telephone +41 58 450 70 00
Fax +41 58 450 70 01
lausanne@lenzstaehelin.com

www.lenzstaehelin.com

Legal Note: The information contained in this UPDATE Newsflash is of general nature and does not constitute legal advice. In case of particular queries, please contact us for specific advice.