Bär & Karrer Briefing

January 2015

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Swiss Federal Government Proposes Fundamental Changes to Swiss Withholding Tax System

On 17 December 2014 the Swiss Federal Finance Department launched an explanatory report and a proposed legislative bill concerning some important changes of the federal withholding tax system. At the core of the proposed reform is a system change of bond interest taxation from the present "debtor system" to a "paying agent system", whereby the duty to withhold and pay tax from relevant revenues would be transferred from the Swiss issuer ("debtor") to the Swiss paying agent of the revenues. The system change would also affect other Swiss and foreign financial revenues (such as dividends, income from fund units etc.) of Swiss resident beneficiaries. The reform would be legally enacted concurrently with the new system of automatic international exchange of tax information, which is expected to be implemented by 2018 or 2019. The Federal Government estimates an annual loss in tax revenues of some CHF 200 million from the reform, compared to current net annual withholding tax revenues of approximately CHF 5 billion. On the other hand, the Federal Government expects positive impulses for the Swiss debt capital market and improved compliance by domestic taxpayers especially with regard to foreign financial revenues that should outweigh the revenue losses.

Background

Under the Federal Withholding Tax Act, certain returns on movable capital are taxed at source through the levy of federal withholding tax at the statutory tax rate of currently 35%[1] from the Swiss debtor of the taxable returns. Withholding tax is imposed on interest paid on bonds and "debentures" by Swiss issuers, interest paid on Swiss bank accounts and deposits, dividends paid by Swiss companies, Swiss lottery gains and certain insurance proceeds. As far as Swiss resident income beneficiaries are concerned, withholding tax is to ultimately secure compliance with the beneficiaries' income declaration duties (compliant resident beneficiaries may either credit withholding tax against their federal and cantonal/communal income tax liability or obtain a cash refund for the tax withheld). However, for non-Swiss resident beneficiaries, withholding tax is principally meant to constitute a final tax burden, unless full or partial relief (generally through refund upon request) is available pursuant to an applicable Swiss international tax treaty. In practice, federal withholding tax on non-Swiss residents' income is an important source of tax revenue for the Federation.

As mentioned above, federal withholding tax currently only covers certain capital income from Swiss sources and is collected based on the "debtor

[1] Special tax rates of 15% or 8% apply to certain insurance products and pension benefits.

system", which means that technically the Swiss payor (debtor) of the taxable income is treated as the person liable for the tax. The nature and the tax residence of the income beneficiary in or outside Switzerland are irrelevant for the personal liability for, and the collection of, the tax (therefore, all resident and non-resident beneficiaries, including tax-exempt institutions such as pension funds, are initially exposed to the deduction of the tax from their revenues). The Swiss payor (debtor) of the taxable amount is legally obliged to withhold and deduct the tax from the taxable payment to the beneficiary and to pay the tax to the Federal Tax Administration, failing which the payment or account credit effectively made to the beneficiary may be deemed to be a net-of-tax payment, i.e. 65% of the taxable amount (grossing-up of tax liability).

The withholding tax's function to secure income tax compliance by Swiss resident taxpayers under the current "debtor system" is only effective with regard to capital income from Swiss sources. Furthermore, the system provides an incentive for Swiss issuers of bonds and similar "collective debt" to seek to avoid the domestic capital market by issuing debt through non-Swiss channels, thereby avoiding Swiss withholding obligations. The Federal Finance Department has recognized that the current "debtor system" of withholding tax has proven to be detrimental for the Swiss debt capital market, especially by turning away international institutional investors, and has lead to a shifting of jobs to foreign financial centers.

Introduction of Paying Agent System

By means of the proposed changed to the "paying agent system" the Federal Government intends to strengthen the Swiss debt capital market, especially for bonds, notes and money market instruments. Furthermore, the reform would extend the securing function of withholding tax to all relevant financial instruments, including those issued by foreign issuers, that are held with a Swiss custodians (in particular, banks). In order to curb the risk that Swiss taxpayers might feel incentivized to place their security assets with a foreign custodian in order to avoid Swiss withholding tax, the reform bill proposes two preventive measures: (a) Compliant Swiss resident taxpayers may opt for voluntary reporting of their income derived from debt securities, collective investment schemes, foreign dividends and Swiss bank deposits to the fiscal authorities by their Swiss custodian. Reported revenues of Swiss resident taxpayers, including interest on Swiss and foreign bonds, notes and "debentures", dividends on foreign shares, income from Swiss and foreign collective investment schemes (excluding underlying dividends from Swiss shares) and from structured financial products, as well as interest from Swiss bank accounts and deposits would be exempt from federal withholding tax. On the other hand, if the Swiss taxpayer does not opt for voluntary reporting by the Swiss paying agent, federal withholding tax would have to be applied to all aforementioned revenues, including those from non-Swiss sources! (b) Introduction and extension of international automatic exchange of information is seen as a precondition for the reform and will pose an increased risk for non-compliant Swiss taxpayers of being discovered. The reform also intends to ensure that non Swiss-resident customers of Swiss banks won't be exposed to an accumulation of withholding tax and cross-border reporting of revenues by the Swiss banks, which would negatively impact on the Swiss financial center.

Main Features of the New System

The paying agent system shifts the legal duty to levy, deduct and pay federal withholding tax on taxable revenues from Swiss issuers to Swiss "paying agents", i.e. primarily custodians such as banks. Swiss and foreign issuers would transfer the gross amount of taxable revenues to their Swiss paying agents. The Swiss paying agent would then need to determine whether withholding tax is applicable to the payment or credit of taxable amounts to its customer and income beneficiary. Generally, reporting based on option exercise by Swiss resident customers or by virtue of cross-border automatic information exchange with regard to foreign resident customers would relieve the Swiss paying agent from the obligation to withhold and pay Swiss withholding tax. Swiss tax exempt pension funds would also benefit from the new system, as they could also opt for direct reporting and thereby avoid the deduction of withholding tax and its subsequent reclaim.

The system change implies at least a partial removal of the traditional Swiss banking secrecy even for Swiss resident bank customers, as far as they opt for direct reporting of their Swiss and foreign financial revenues by their Swiss custodians. Swiss resident bank customers who do not opt for direct reporting would still be exposed to withholding tax deduction (even on foreign financial revenues) and would be entitled to reclaim or credit the withholding taxes suffered, if they meet all conditions for such reclaims (in particular, full declaration in their income tax returns or financial accounts, beneficial ownership, absence of tax avoidance).

Role of Automatic Information Exchange

The Federal Government intends to take benefit from an increasing number of Swiss double taxation treaties with featuring full exchange of information, specific tax information exchange agreements entered into with traditional offshore centers and the future system of cross-border automatic information exchange to curb tax evasion efforts by Swiss resident taxpayers who try to circumvent the system by holding their financial assets through a non-Swiss custodian. Therefore, the Federal Government intends to put the new system into effect simultaneously with the introduction of automatic exchange of tax information, which is expected to happen in 2018 or 2019. On the other hand, automatic information exchange with foreign tax authorities will remove the necessity to apply withholding tax on revenues from debt securities of non-Swiss resident bank customers.

Carve-out of Swiss Dividends

Dividends from Swiss equity securities and distributions of underlying Swiss dividends by collective investment schemes will remain fully subject to Swiss withholding tax imposed under the existing "debtor system".

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