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TAX NEWS: Landmark Judgments Regarding the Refund of Swiss Withholding Tax

Introduction

On May 5, 2015 the Swiss Federal Supreme Court held a public hearing about two cases relating to the reclaim of Swiss withholding tax (WHT) in connection with arbitrage cases and issued its long awaited decisions. Two Danish banks issued the question on treaty entitlement for the refund of WHT based on the Swiss-Danish double tax treaty (DTT-DK) in connection with total return swaps and futures products.

The judgments have been decided to the disadvantage of the banks and in favor of the Swiss Federal Tax Administration (SFTA). The decisions of the lower tribunal, the Federal Administrative Tribunal, were overturned. As a result, the entitlement for the refund of WHT was denied, already made repayments of WHT have to be refunded and late payment interests of 5% are due since the time of the first reclaim of the SFTA.

Case 1: Total Return SWAP (2C_364/2012; 2C_377/2012)

This section reproduces the note of R. Danon, Swiss Supreme Court Rules Against Taxpayer in Beneficial Ownership Case, published in Tax Analysts 2015

Case

A Danish bank issued a total return swap to counterparties with underlying shares in publicly listed Swiss companies. At the maturity of the swap, the bank had to pay to the counterparty an amount equal to the returns generated during the running time, i.e. dividends, and the capital gains from the underlying shares. The bank received as remuneration a fixed interest based on the LIBOR plus an additional margin.

To hedge its risk resulting from the total return swap and as it is frequently the case, the bank bought the underlying shares of the total return swap. After receiving the dividend payments, the bank filed a request for the refund of WHT (35% of the gross dividend payment) with the SFTA based on the DTT-DK.

Unlike the OECD Model Tax Convention, the tax treaty in force at the time provided Switzerland with no limited right to tax dividends, which were thus exclusively taxable in Denmark. Further, the dividend article of the treaty did not contain the beneficial ownership requirement or any specific anti-abuse rule. At the beginning, the SFTA granted some requests of the bank and repaid the WHT. After a certain time, the SFTA questioned the entitlement of the bank based on the DTT-DK due to lack of beneficial ownership, demanded the repayment of former repayments and qualified bank's behavior as treaty abuse.

Decisions

Lower Court Decision of 7 March 2012

The case gave the Federal Administrative Tribunal the opportunity to engage into a fairly detailed analysis of the beneficial ownership requirement.

To begin with, the court confirmed the position traditionally taken by Swiss case law and commentators that beneficial ownership is an implicit requirement that applies to all tax treaties. The fact that the tax treaty concluded with Denmark did not expressly contain this requirement was thus irrelevant. As to its content, the Federal Administrative Tribunal held that beneficial ownership focuses on the power to decide on the use of the income derived from the state of source. Such power should be understood on the basis of a substance over form approach. Accordingly, for the Federal Administrative Tribunal, beneficial ownership may be denied where the recipient is under a legal or factual obligation to pass on the income to a third party. Critical, in this respect, is therefore the reciprocal interdependence between the income and the obligation to pass it to a non-resident.

Relying on the foregoing principles, the Federal Administrative Tribunal ruled in favor of the taxpayer. Specifically, the court found that no legal or factual obligation to pass on the dividends existed in the present instance. Indeed, for the court, the bank would have been obliged to pay the dividend amount to the counterparty even if it had not received the Swiss source dividends. Conversely, the bank would have received the dividends even if it had not been obliged to pay the dividend amount to the counterparty. Therefore, the Federal Administrative Tribunal arrived at the conclusion that no interdependence preventing beneficial ownership existed in the present instance: the bank was free to decide, regardless of the swap contracts, whether or not to buy the shares.

This being said, the court considered that the arrangement at stake still had to be tested in light of the general reservation of abuse doctrine. For this purpose, the court relied on the earlier case law of the Federal Supreme Court pursuant to which all tax treaties are subject to an implicit reservation of abuse. Under this case law, which was developed in the famous ApS judgment decided in 2005 (Federal Tribunal Judgment 2A.239/2005 of 28 November 2005), tax treaty benefits may in essence be denied by Switzerland where the entity in the other contracting State does not exercise any genuine commercial activity ("aktive Geschäftstätigkeit") within the meaning of the drafting suggestions of the OECD Commentary to art. 1. Yet, because the Danish bank was exercising a genuine commercial activity, the structure was not regarded as abusive.

Therefore, since the bank was regarded as the beneficial of the Swiss source dividends and that the structure was not found to be abusive, the Federal Administrative Tribunal ruled in favor of the taxpayer and that the latter was entitled to a full refund of the Swiss withholding tax.

Decision of Federal Supreme Court of 5 May 2015

Further to the appeal of the SFTA, the findings of the Supreme Court were very much expected by the international tax community, mainly for two reasons. First of all, the case offered the Supreme Court the opportunity to address the application of the beneficial ownership requirement to total return swaps, which had received less consideration and was still controversial. Secondly, commentators were also hoping that the Supreme Court would revisit, or at least clarify, its case law on the implicit reservation of abuse, since this argument had been brought up by the lower court. According to most commentators, it is indeed controversial to condition the absence of abuse to a commercial activity in the residence state when the tax treaty does not expressly contain such a requirement.

Although the written judgment of the case is not yet available, it appears that the findings of the Supreme Court will be primarily focusing on beneficial ownership. Therefore, the principles developed in the ApS case are unfortunately unlikely to be reconsidered. In essence, the Supreme Court indeed reversed the analysis of the lower court and considered that, as a result of the total return swaps arrangements the bank had a de facto obligation to pass on the dividends to non-residents and hence could not be regarded as the beneficial owner thereof. In other words, the Supreme Court confirmed the interdependence of the transactions, which had been ruled out by the Federal Administrative Tribunal. Further, this conclusion appears to have been strengthened by the short time lapse between the acquisition and the sale of the shares.

First Critical Remarks

It appears that the Supreme Court gave a rather wide interpretation to the notion of beneficial ownership and interdependence. In essence, it seems that it considered the facts at hand to be very much akin a classical "stepping stone" or "direct conduit" treaty shopping structure involving a mere conduit company with very limited powers passing on treaty favored income to non-residents.

Therefore, once the written judgment of the Supreme Court is released, it will be interesting to compare its findings with the definition of beneficial ownership contained in the 2014 update to the OECD Commentary to which Switzerland made no reservation or observation. One of the concerns that led to the adoption of the 2014 OECD Commentary was indeed that an overly broad definition of beneficial ownership may have unintended effects in bona fide transactions. It will therefore be important to monitor the evolution of tax treaty policy in this area, in particular the current work done by the OECD with respect to treaty abuse.

Case 2: Futures Products (2C_895/2012)

Case

A Danish bank issued futures contracts to counterparties over brokers. The underlying assets to these contracts were the stocks listed in the Swiss Market Index (SMI). To hedge its risk on the futures contracts, the bank bought shares in all companies listed in the SMI over brokers. At time of expiry, the bank repurchased the futures contracts and sold the shares. For the purchase/sale of the shares and futures different brokers were used. The bank's transactions were financed by its parent company.

As in case 1, the bank requested the refund of WHT due on dividend payments of the underlying shares. The SFTA repaid the WHT at the beginning. Later, the SFTA denied the refund, demanded the repayment of former repayments and qualified bank's behavior as treaty abuse.

Decision of the Federal Supreme Court of 5 May 2015

In the second case, the facts available to the Supreme Court were less clear. However, the majority of the judges was of the opinion that with regard to the circumstances of the case at hand the volume of the futures contracts and the fact that only few parties were involved builds enough evidence that the bank cannot be regarded as beneficial owner of the dividend payments and was furthermore obliged to forward the dividend payments to the counterparties in the EU and US.

Claw Back of already Paid Out Refunds and Interest Payments

In both decisions, the Supreme Court ruled that the SFTA is entitled to reclaim the already made refunds of WHT based on the legal principle of unjust enrichment. The applicable statute of limitation on these cases is three years. Since the SFTA reclaimed the repayment within this three years period, the claims were not time barred.

Additionally to the repayment, the banks are obliged to pay 5% interest on the reclaimed amount beginning from the first request for repayment by the SFTA.

Conclusion

Both decisions will have a significant impact on the numerous same or similar cases pending at the SFTA or the Federal Administrative Court. It is to be expected that these cases will be decided soon by the respective instances under consideration of Federal Supreme Court's decisions.

Irrespective of the above mentioned decisions each case has to be analyzed on its own facts to decide if a possible appeal is meaningful or not. However, the written reasoning of these cases, which can be expected in course of the next weeks, will further clarify Federal Supreme Court's opinion and provide information useful for the assessment of other cases.

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