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Refund of Swiss withholding taxes to US regulated investment companies

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Introduction
International mutual funds investing in Swiss stocks, bonds and notes are confronted with a 35% withholding tax imposed on dividends and bond interest. The Swiss issuer must deduct and withhold such tax from the taxable payments. Full or partial relief from the Swiss withholding tax may be available to international investors through applicable Swiss tax treaties. The treaties typically provide for a 15% non-refundable Swiss tax in respect of portfolio dividends. With regard to interest, the treaty rate is usually 5% or 0% (eg treaties with the US and UK). International investors must normally file a tax refund claim with the Swiss tax authorities to benefit from the reduced tax rate; relief at source is generally not available.

Background
US mutual funds are often structured as corporate entities. Even though they appear to be resident in the US for tax treaty purposes, they have faced problems in obtaining Swiss tax refunds under the revised Switzerland-US income tax treaty of October 2 1996.

Article 10 of the aforementioned 1996 treaty provides that dividends derived and beneficially owned by a resident of a contracting state may be taxed in that state, but may also be taxed in the contracting state in which such dividends arise according to the laws of such state. However, the tax in the source country must not exceed 15% of the gross dividends (the withholding tax rate is reduced to 5% where the beneficial owner of the dividend is a company that holds directly at least 10% of the voting stock of the company paying the dividends). Under article 11 of the 1996 treaty, interest derived and beneficially owned by a resident of a contracting state shall be taxable only in that state.

From 1998 onwards, the Swiss Federal Tax Administration (FTA) refused to process Swiss withholding tax refund claims filed by US mutual funds, based on the view that a US mutual fund could not be regarded as the beneficial owner of the income received by the fund if it has opted to be treated as a regulated investment company (RIC) for US federal income tax purposes. Basically, a RIC may deduct any income distributions made to its shareholders from its taxable income. Hence the RIC's net income is effectively not taxed at the RIC's level to the extent that it is distributed to the shareholders. To be eligible for RIC tax treatment, a US corporate fund must distribute at least 90% of its gross income to the shareholders in the current period. Any income not currently distributed is subject to a 4% excise tax, unless at least 98% of the gross income is currently distributed. The FTA argued that the RIC tax regime effectively forces the US fund to pass on the income to the shareholders currently to secure the US tax benefit, and concluded that RICs do not beneficially own their income. Instead, the RIC shareholders could eventually be eligible for Swiss tax refunds in respect of income distributions received by using tax treaties applicable to them.

This led to lengthy negotiations between representatives of the US mutual fund industry and the FTA as to the application of the 1996 treaty to RICs and/or their shareholders, respectively. Finally, in September 2001, the FTA announced a new Swiss tax refund procedure for RICs for 1998 through 2001 (the September Announcement). It is expected that the solution set forth in the September Announcement of the FTA will substantially remain valid for 2002 and onwards.
Content of the September Announcement

The solution reflected in the September Announcement was reached after the FTA had established a joint working group on collective investment vehicles that included representatives from the FTA, the Swiss banks and the Swiss Investment Fund Association. The working group examined the issues and held several discussion rounds with the Investment Company Institute (ICI) in Washington as the representative of the US mutual fund industry.

As it stands now, the ICI representatives were not successful in convincing the FTA that RICs should themselves be regarded as entitled to claim Swiss tax refunds based on the 1996 treaty in their own right. They had taken the view that RICs should be entitled to claim treaty benefits on their own behalf, but subject to the limitation that tax refunds would only be granted in the proportion of RIC shares being held by US residents, as defined in the treaty. The ICI representatives had suggested that RICs should be subject to particular reporting and documentation requirements to evidence the proportion of ultimate beneficial ownership by US residents. Difficulties in establishing the identity of the ultimate shareholders would be approached with certificates from the custodian banks on the percentage of US resident versus non-US resident beneficiaries. The ICI proposals did not provide for any current disclosure of names and further data of the ultimate beneficiaries. However, the data submitted with the tax refund claims would be subject to subsequent audit and verification by the FTA.

The Director of the FTA has maintained the position that a US RIC cannot be recognized as the beneficial owner of the investment income derived by it. Consequently a RIC cannot claim any Swiss tax refunds in its own right. However, a RIC may file Swiss withholding tax claims based on articles 10 and 11 of the 1996 treaty in its own name, but acting as an agent for its US resident shareholders. Tax refunds in accordance with articles 10 and 11 of the 1996 treaty will be made by the FTA to the RIC on the following basis:

- if the RIC demonstrates that more than 95% of its shares are held by persons resident in the US, the FTA will grant an integral tax refund pursuant to articles 10 and 11 of the 1996 treaty, as if all RIC shareholders were resident in the US;
- if the proportion of US resident shareholders of the RIC is 95% or lower, the tax refund to the RIC will be made in the proportion of US resident shareholders;
- the RIC must include information on the percentage of its US resident shareholders with each tax refund claim filed with the FTA. For that purpose, the RIC has to make a distinction between shares held directly by investors and shares held indirectly though one or more brokers. The RIC must determine the proportion of its shares held directly by US tax residents on the basis of the documentation it has to prepare for the purposes of the reporting to the Internal Revenue Service (IRS) in connection with US withholding taxes on payments to non-US persons. The RIC may generally assume that the US proportion of directly held shares reflects the US proportion of all of its shares, including those held through brokers. In the event that all RIC shares are held through brokers, the RIC may, after consulting the FTA, determine the US portion of shares by other means;
- the FTA reserves the right to examine the accuracy of the statements made by a RIC on a random basis; and
- for refund claims pertaining to Swiss taxes withheld during the years 1998-2001, the proportion of US shareholders is to be determined as of March 31 2001. For each subsequent year, the situation as of March 31 of that year will be considered relevant.

The September Announcement contains further guidance as to practical issues connected with Swiss tax refund claims. Claims that had already been filed by RICs in respect of taxes withheld during the years 1998-2001 must be supplemented with a special “Attachment RIC” and a certificate from the IRS (Form 6166). Refund claims in respect of the year 1998 had to be filed by December 31 2001. From the year 2002, RICs will have to use the new Form 82R for making Swiss tax refund requests. A separate request for each year will have to be made.

Summary

For the time being the FTA has maintained its position that US RICs are not to be regarded as the beneficial owners of their investment income (however, the FTA has indicated that it will review its position at a later stage). Hence, the FTA accepts treaty-based Swiss tax refund claims from RICs only on the basis that the RIC acts as an agent for its US resident shareholders. The RICs are not required to submit names and other details of the RIC shareholders or ultimate beneficiaries to the FTA when claiming Swiss tax refunds. RICs must, however, indicate the percentage of their direct shareholders resident in the US and have to submit a certificate from the IRS on Form 6166 to the FTA. The FTA has the right to audit the documentation submitted and to eventually reclaim tax refunds wrongfully obtained.