Switzerland

Court Rulings on Dividend Stripping and Denial of Swiss Tax Treaty Benefits

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Two recent judgments by the Swiss Federal Supreme Court concerned Danish resident banks that were denied refunds of Swiss withholding taxes on dividends derived from Swiss publicly traded shares on grounds of lacking beneficial ownership, even though the applicable former Denmark-Switzerland Income and Capital Tax Treaty (1973)[1] did not explicitly mention such a requirement. The Supreme Court overruled the decisions of a lower court granting treaty benefits to the banks.

1. Introduction

In judgments rendered by the Swiss Federal Supreme Court on 5 May 2015,[2] two Danish resident banks were denied refunds of Swiss withholding taxes suffered on dividends derived from Swiss publicly traded shares on grounds of lacking beneficial ownership, even though the former Denmark-Switzerland Income and Capital Tax Treaty (1973), which was applicable to the two cases, did not explicitly mention such a requirement. The Supreme Court overruled the Federal Administrative Court (FAC),[3] which had previously found that, under the factual circumstances, tax treaty benefits had to be granted to the Danish banks.

In contrast to the FAC, the Supreme Court concluded that the claimant Danish banks had engaged in abusive "dividend stripping" schemes and were thus not to be regarded as the beneficial owners of the dividends in question. In both cases, the Danish banks had carried out so-called arbitrage trading or securities financing strategies with regard to the Swiss shares, involving hedging strategies based on equity derivatives. The Supreme Court not only rejected the pending withholding tax reclaims of the Danish banks, but also upheld the claims raised by the Swiss Federal Tax Administration (SFTA) for repayment of withholding taxes already refunded in the past.

2. The Swaps Case

2.1. Factual background

The claimant, a Danish bank, sold total return swaps on baskets of Swiss listed shares via a broker to other banks residing in five different third countries (short derivative position). Dividends would generally fall due on the underlying basket shares during the swap contract period. The Swiss tax treaties with the counterparties' home countries generally provided for a 15% non-refundable dividend withholding tax.

Under the terms of the swaps, the Danish bank made a notional payment to the counterparty on maturity, reflecting the performance of the share price and the entire dividend return, which were to be exchanged for a payment by the counterparty comprised of interest on the notional invested amount at the LIBOR rate, plus a margin and compensation for any negative performance of the share price over the contract period. The two payments were then netted against each other.

In order to cover (hedge) its financial exposure under the swaps, the Danish bank purchased an equivalent amount of the underlying Swiss shares in the market via a broker (equity long position). Upon maturity, the swaps would normally be cash settled and the Danish bank would sell the Swiss shares on the market, again via a specialized broker. The identities of the ultimate sellers and buyers of the Swiss shares were unknown. The arrangements typically lasted for approximately six months, generally with dividends falling due during the contract terms. As a shareholder of record, the Danish bank received the dividends net of the 35% applicable Swiss withholding tax and subsequently filed for a full refund of the Swiss tax withheld, relying on the terms of the then applicable Denmark-Switzerland income tax treaty.

In 2006, the Danish bank received refunds of initially deducted Swiss withholding taxes to the tune of CHF 37.9 million. The aggregate tax reclaims raised by the Danish bank for 2007 and 2008 of CHF 53.6 million were denied by the SFTA. In that context, the SFTA also demanded repayment of the already refunded taxes for 2006. The SFTA essentially took the position that the transactions had no business

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1. **SR 0-672.931.41.**
2. CH: Federal Supreme Court decisions 2C_364 and 377/2012 and 2C_895/2012.
3. CH: FAC rulings A-6537/2010 (7 Mar. 2012) and A-1246/2011 (23 July 2012).

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substance other than the objective to secure the full refund of the Swiss withholding taxes. According to the SFTA, the Danish bank had transferred the entire dividend benefits without any withholding tax burden to the swap counterparties, for which the bank received a merely nominal compensation in the form of a small profit margin. The combination of the swaps with the equity long positions served to transfer all risks and benefits pertaining to the shares and the dividends to the swap counterparties. The SFTA determined a causal nexus between the swaps and the temporary holding of the shares, as the acquisition of the shares would not have been required but for the entry into the swaps. In addition, the SFTA assumed that the shares had ultimately been acquired from the swap counterparties and sold back to those parties after the cash settlement of the swaps.

2.2. Considerations of the Federal Administrative Court[4]

Upon appeal by the Danish bank, the FAC essentially established that, under the given circumstances, the Danish bank held the beneficial ownership to the shares and the dividends. Thus, the Court held that it was not necessary to address the fundamental issue of whether beneficial ownership was a prerequisite for tax treaty benefits under the former applicable Swiss tax treaty with Denmark, which did not include any express "beneficial owner" language.[5] Furthermore, the Court found that there was no issue of tax treaty abuse, as the Danish bank had business substance in Denmark. The FAC referred to the jurisprudence of the Supreme Court,[6] according to which – in the absence of a specific anti-abuse provision in the tax treaty in question – abuse of a treaty will be assumed only when the corporate claimant of tax treaty benefits does not carry on any genuine, active business in the country of its tax residence; an eligible business activity generally requires the presence of personnel and physical premises and equipment in accordance with the nature of the activities.

The decision of the FAC in favour of the Danish bank was fundamentally based on its determination that the claimant held beneficial ownership and was not abusing the tax treaty. Focusing on the beneficial ownership analysis, the Court essentially referred to the Commentary on the OECD Model Convention (OECD Model) and various Swiss and international scholars, in particular, the Swiss dissertation by Baumgartner.[7] The Court emphasized that the beneficial owner concept serves as a condition precedent for tax treaty benefits with regard to dividends, interest and royalties (similar to the residence requirement); it does not constitute an anti-abuse rule. The Court confirmed the general doctrine that the beneficial ownership concept examines the intensity of the relation between a taxpayer and a taxable object (income) from an economic perspective, thereby adopting a substance-over-form approach.

According to the FAC, the beneficial owner quality is essentially determined by the degree of the decision power and control of the income recipient over the application of the dividends received. The Court rejected the conclusion of the SFTA that the Danish bank was obliged under the swaps to fully transmit the dividend return to the swap counterparties. The Court held that the swap agreements did not stipulate any such obligation; the agreements rather required the swap seller to make a payment to the buyer reflecting the entire performance of the underlying shares, including any dividends, over the contract period. The Court further held that the swap agreements did not stipulate any legal obligation of the swap seller to hedge its payment obligations arising under the contracts, or to buy the underlying shares.

Moreover, the FAC examined whether there was any de facto obligation to transfer the dividends. For this test, the Court, applying the criteria developed by Baumgartner,[8] questioned whether the transactions were "mutually dependent" on each other. On the one hand, it had to be tested whether the Danish bank's payment obligation under the swaps would also have persisted in the absence of the actual receipt of the original dividends. On the other hand, it had to be determined whether the Danish bank would have earned the dividends even in the absence of the swap obligations. The Court concluded that both questions had to be affirmed and that there was no mutual dependence. Finally, the Court rejected the argument of the SFTA that the Danish bank's beneficial owner quality had to be denied, as it retained only a very small fraction of the dividends for itself. For the Court, that sort of ex post analysis was not appropriate; the beneficial ownership must rather be determined at the time the income arises. The Court recognized that as a result of the swap arrangements, the swap counterparties had effectively assumed the economic risks with regard to the dividends; however, the Court emphasized that the decision to actually purchase the underlying shares and to hedge the swap obligations was at the full discretion of the Danish bank.

A further contentious issue the FAC had to address – which was apparently at the heart of the entire case – was the extent of the Danish bank's procedural duty to cooperate with the SFTA in assessing the relevant facts. The SFTA generally assumed that the Danish bank had purchased the shares from the swap counterparties and eventually sold the shares back to those parties, hinting at an abusive, bilateral and circular dividend-stripping scheme. To support that assumption, the SFTA pointed to the simultaneous entry into the swaps and purchase of the underlying shares, and the simultaneous dissolution of the swaps and sale of the underlying shares, whereby the positions were entered into shortly before the dividend dates and were held only for three to six months. Against that background, the SFTA had asked the Danish bank to disclose the identity of the ultimate swap counterparties. However, the Danish bank refused to do so, pointing to Danish banking laws prohibiting the disclosure of bank client names; instead the Danish bank provided a certificate issued by a Swiss notary, according to which the swap counterparties were resident in five different jurisdictions and were not identical with the buyers or sellers of the underlying shares.

The Court pointed to the legal doctrine according to which the cooperation duty of the claimant is limited by factors of necessity and sustainability. The Court emphasized that the Danish bank must not be expected to breach its customer confidentiality requirements and

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4. **FAC ruling A-6537/2010 (7 Mar. 2012).**
5. Considerations 3.3.2, 3.4 and 6.
6. Supreme Court decision 2A_239/2005 (28 Nov. 2005), consideration 3.6.3.
7. B. Baumgartner, *Das Konzept des beneficial owner im internationalen Steuerrecht der Schweiz* (Schulthess Verlag 2010).
8. Baumgartner, *supra* n. 7.

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expose itself to criminal law sanctions. The Court deemed the notarial certificate to be sufficient proof of the Danish bank's assertion that the swap counterparties were not identical with the sellers and buyers of the underlying Swiss shares.

2.3. Decision of the Supreme Court[9]

The Supreme Court reversed the decision of the FAC and ruled wholly in favour of the SFTA. First, the Supreme Court confirmed its practice, according to which beneficial ownership is a general prerequisite for tax treaty benefits, even under older tax treaties which do not include any express beneficial owner language. However, the Court left open the question of the relation between the beneficial owner requirement and the reservation of tax treaty abuse. The Court confirmed the general analysis of the beneficial owner concept made by the FAC in that the beneficial owner capacity is to be measured by the degree of the taxpayer's decision power over the application of an item of income from an economic perspective (substance over form). In particular, the Supreme Court held that a person cannot be regarded as the beneficial owner, if, based on contractual or merely "factual obligations or similar restrictions" that already exist at the time of the payment or receipt of the income in question, it is bound to transfer the income to someone else. Basically, the Supreme Court applied the criteria developed by Baumgartner to assess whether a person is effectively under a "legal or merely factual obligation or similar restriction" to transfer the income in question. According to Baumgartner, two criteria must be cumulatively met, namely (i) the realization of the income must be dependent upon the obligation to transfer the income and (ii) the obligation to transfer the income must be dependent upon the actual receipt of the income.

The Supreme Court interpreted and applied these tests in light of the total return swaps of the Danish bank, covered (hedged) by the underlying shares, as follows: The first dependency concerns the question as to whether the Danish bank was obliged to hedge its swap obligations by purchasing the underlying Swiss shares. The second dependency relates to the question as to whether the Danish bank was obliged to transfer the dividends arising on the purchased shares to the swap counterparties.

With regard to the first test, the Supreme Court held that, although the Danish bank was neither legally nor factually obliged to hedge its swap positions through the purchase of the underlying shares, it had, in fact, a number of "compelling reasons" to completely hedge all of its total return swap positions without any exceptions and simultaneously with the existence of the positions. "The same coincidence existed in each case with regard to the dissolution of the swaps and the resales of the shares."[10] The Supreme Court held that, because the Danish bank had undertaken to pass on the entire performance of the underlying shares, including the entire dividend, to the swap counterparties, it had to safeguard its own interests through the purchase of the relevant underlying shares, thus enabling it to effectively meet its payment obligations under the swaps using the dividends collected. The Supreme Court found that the interest earned under the swaps effectively enabled the Danish bank to debt-finance the purchase of the underlying shares. The Court thus found an apparent interdependence between the acquisition and the financing of the underlying shares.

Moreover, the Supreme Court saw a nexus between the fact that the swap arrangements effectively transferred the entire economic exposure to the underlying shares, including the share price development and the risk and benefit of the dividends, to the swap counterparties (while the Danish bank was fully hedged against those risks and benefits) and the small net profit margin earned by the Danish bank. The Court found that, in the absence of such a full hedge of the risks, the swaps could not have been entered into with comparable terms. In essence, the Supreme Court concluded that the swaps and the long stock positions were mutually dependent on each other.

With regard to the second test, the Supreme Court conceded that the swaps as such did not require the Danish bank to transfer the (original) dividends on the underlying shares to the swap counterparty, but only to make economically equivalent payments. However, the Court determined an apparent economic nexus between the different cash flows in question (i.e. the receipt of the original dividends including the refund of the withholding tax on the long share positions and the payments made under the swaps). Further, the Court pointed to the fact that the payments to be made under the swaps exactly matched the actual performance (whether positive or negative) of the underlying shares as a matter of concrete legal agreements. This led the Supreme Court to conclude that the Danish bank had "compelling reasons" to actually hedge itself by acquiring the underlying shares and receiving the dividends pertaining thereto.

Overall, the Supreme Court concluded that the Danish bank was under a de facto obligation to pass on the entire dividend benefits to the swap counterparties, in direct analogy to the "stepping-stone" theory:

> The nexus between the dividend collection and the contractual obligation to pass on the dividends must be assumed […] The shares were systematically purchased prior to the dividend maturity and for the purpose of passing-on the collected dividends fully and free of any withholding tax to the swap counterparties, which were neither Swiss nor Danish resident […] and such passing-on to non-resident parties had been planned well before the dividend maturity […] All those counterparties had their domiciles in states whose the tax treaties provided only for a residual withholding tax burden of 15%.[11]

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9. **Decision 2C_364 and 377/2012 (5 May 2015).**
10. Consideration 6.3.1.
11. Consideration 6.4.2.

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3. Reclaim of Already Refunded Withholding Taxes

The Supreme Court ruled with a three-two majority in favour of the SFTA with regard to the withholding tax claw-back reclaims. The reasons given by the Court are rather remarkable. First, the Court drew a distinction between withholding tax refunds made to Swiss resident claimants based on domestic law (the federal Withholding Tax Act) and those granted to foreign resident claimants, which may be based only on applicable income taxation treaties. As far as domestic tax reclaims are concerned, article 51(2) of the Withholding Tax Act stipulates the right of the SFTA to subsequently review such "routinely" granted tax refunds within three years, implying that they may be claimed back by the tax authorities if the refunds appear to be without justification upon review. However, the Supreme Court confirmed that such a subsequent review is neither provided for under the (former) Denmark-Switzerland treaty nor under the Swiss Ordinance[12] implementing that treaty. Under article 3(1) of that Ordinance, the SFTA will examine any Swiss withholding tax refund claim made under the treaty for correctness and justification; under paragraph 2 of the same provision, the SFTA will issue a formal decision if they approve the tax reclaim, while paragraph 3 deals with the rejection of a claim, in which case the decision must be communicated in writing and include a justification and advice on available legal remedies.

The Supreme Court found that article 3 of the Ordinance was applicable to the case at hand and held that, in light of that provision, the SFTA would not have been entitled to first positively decide on the withholding tax reclaims and thereafter revoke such decision with a second order, even if that second order were based on a careful review and were properly justified. However, it would have been admissible for the SFTA to initially grant the tax refund "without prejudice", adding a warning in writing that the particular refund was granted based on a summary review only and would thus remain subject to subsequent detailed review by the SFTA.

The Supreme Court further determined that the tax refund made by the SFTA in September 2006 was both informal and unconditional. There were no indications of any formal decision. The Supreme Court again emphasized that, in contrast to the regime stipulated by article 51 of the Withholding Tax Act, under article 3 of the Ordinance, there is no withholding tax refund without a prior decision of the SFTA. The SFTA are supposed to review the tax refund request and examine whether the request is well founded. Ultimately, the SFTA must inform the claimant in writing of their decision. The Court confirmed once again that the repayment claim for already refunded withholding taxes based on the (former) Denmark-Switzerland Income and Capital Tax Treaty (1973) could not be based on article 51(2) of the Withholding Tax Act.

Remarkably, the Supreme Court further rejected article 12 of the Federal Act on Administrative Criminal Law[13] as a basis for such a repayment claim. Under that rule, tax benefits obtained as a result of a punishable offense against federal administrative law must be returned. The Supreme Court concluded that application of that rule to the case at hand would have required that the undue refund of withholding taxes have been based on a punishable infringement of the federal administrative law, such as withholding tax evasion. The application of article 12 requires only the fulfilment of the objective criteria of a punishable offense; an actual punishment (which would also require subjective guilt) is not prescribed. Notably, withholding tax evasion may also be committed in the form of unlawfully obtaining a refund of withholding tax. However, the Supreme Court found that in the case at hand, there was no question of a punishable infringement, but only an issue as to whether the Danish bank did hold beneficial ownership with regard to the dividends that had given rise to the tax refunds in 2006. This conclusion of the Supreme Court appears to suggest that claiming and obtaining a refund of Swiss federal withholding tax without holding beneficial ownership of the income in question, may constitute a violation of the tax treaty (and thus trigger the denial of tax treaty benefits), but it does not fulfil the objective criteria of evasion of Swiss federal withholding tax. It remains to be seen whether the Supreme Court will uphold that approach in its future jurisprudence.

In a final twist, the Supreme Court pointed out that, despite the fact that the repayment claims of the SFTA could be based on neither article 51(2) of the Withholding Tax Act, nor on article 12 of the Federal Act on Administrative Criminal Law, and despite the fact that the SFTA had not fulfilled the requirements of article 3 of the Ordinance, the repayment claims of the SFTA were not groundless. The Court referred to the civil law concept of unjust enrichment, which is applicable in the sphere of public law, as well. The Court noted that a tax refund payment by the government would not be legally baseless if it were based on an administrative order (decision) that was objectively faulty, but did enter into legal force and if there were no legal grounds to revise that order. In such a situation, the ordering authority would be bound to its order. However, the Supreme Court pointed to the fact that, in the case at hand, the SFTA had not issued any formal order (decision) in connection with the tax refunds granted in 2006; those refunds were rather found to be "informal". On that basis, the Supreme Court concluded that there was no reason not to classify the repayment claim of the SFTA as a (principally valid) claim based on unjust enrichment.

The authors find this conclusion of the Supreme Court somewhat problematic, as it effectively means that the SFTA were rewarded for their non-compliance with the applicable Ordinance. Had the SFTA communicated their original tax refund in writing to the Danish bank in accordance with the Ordinance, a subsequent reclaim of the tax refund based on unjust enrichment would have been legally excluded in the absence of legal grounds for a revision of the order. This boils down to an application of the domestic Swiss rules on subsequent review of informally, provisionally granted refunds of federal withholding tax through the backdoor, which infringes the principles of the tax treaties and the specific Swiss procedural rules thereunder. Under the (former) Denmark-Switzerland treaty (as is the case under many other Swiss tax treaties), merely "informal" refunds of Swiss withholding tax, subject to a subsequent detailed review by the SFTA, are not provided for. Under those tax treaties, the thorough review of the foreign applicant's request for a refund of Swiss withholding

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12. Ordinance on the (former) Switzerland-Denmark Income and Capital Tax Treaty (18 Dec. 1974), SR 672.931.41.
13. 22 Mar. 1974, SR 313.0.

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tax must occur before the refund is either granted or denied. At the very least, tax refunds granted without prior full review should have been explicitly labelled by the SFTA as preliminary, under reservation of subsequent full review. In the authors' opinion, the completely "informal" and unconditional granting of the tax refunds by the SFTA should indeed have been construed as orders in accordance with the Ordinance, implying a prior full review of the tax refund requests by the SFTA, regardless of whether such a review actually took place. On that basis, the tax repayment claims should have been dismissed.

The Supreme Court went on to analyse whether the tax repayment claim by the SFTA was time barred. Under Swiss civil law (article 67(1) of the Swiss Code of Obligations), such claims are subject to a one-year statute of limitations, which runs from the date on which the creditor has gained knowledge of the basis of the claim. The statute of limitations would generally be interrupted by legal enforcement actions of the creditor. The Supreme Court stated that article 3 of the Ordinance does not set forth any rules on a statute of limitations, whilst article 51 of the Withholding Tax Act provides for a three-year statute of limitations – in reality, the SFTA have three years after an informal, provisional refund of withholding tax to subsequently examine the matter. While the Supreme Court held that article 51 could not be applied to the (tax treaty) case at hand, the Court nonetheless found that the three-year deadline could be based on a general principle of law, as the regulation that is "inherent to the law of federal withholding tax" should take precedence over the one-year statute of limitation under the Code of Obligations. The Supreme Court further concluded that the application of the three-year statute of limitations would not favour the source state over the taxpayer's residence state, and also would not result in any disadvantage for the foreign claimant of Swiss withholding tax refunds in its relations with the Swiss tax authorities. Finally, the Supreme Court determined that the SFTA had "at least" interrupted the three-year deadline with their letter dated 11 March 2009, by which the SFTA informed the Danish bank that it considered the tax refunds granted in 2006 to be based on "abusive" transactions, such that the refunds of withholding tax were not justified.

While the Supreme Court stated that, in the case at hand, the Danish bank had failed throughout the procedure to substantiate that the transaction pattern underlying the already granted refunds of withholding taxes materially differed from the transactions that led to a rejection of the pending tax reclaims, the Court decided, "not least in view of the financial dimension of the transactions concerned",[14] to refer the matter back to the SFTA for a full investigation of the past transactions in light of the Court's considerations that led to the rejection of the pending tax reclaims.

The authors find the reasoning of the Supreme Court in support of the claw-back reclaims by the SFTA of already granted withholding tax refunds, to be rather problematic. Not only did the Supreme Court effectively sanction the non-compliance of the SFTA with the rules of the Ordinance (which would have required a thorough review of the withholding tax refund request prior to granting any refunds and a formal decision in writing in any case), but also effectively "saved" the claims of the SFTA through the application of a longer, three-year statute of limitations, which is not foreseen under the civil law on which the claw-back tax reclaims were legally based. This casts a significant degree of legal uncertainty over any Swiss withholding tax reclaims received by foreign resident taxpayers based on an applicable Swiss tax treaty.

4. The Futures Case

4.1. Factual background

In this case, another Danish bank during 2006 and 2007 sold standardized SMI index futures traded on the Eurex Exchange via a broker, shortly before the Swiss "dividend seasons" started, as part of an "index arbitrage trading" strategy. In order to cover (hedge) its "synthetic short position" in the SMI basket, the Danish bank purchased corresponding amounts of the shares comprising the SMI basket (physical long position) through another broker for a total of CHF 3.745 billion. The purchase of the shares was financed with an interest-bearing loan granted by the Swedish parent company of the Danish bank. Both the synthetic short and physical long positions were unwound in June 2007 upon a maturity date of the futures. In 2006, the Danish bank derived gross dividends from the SMI shares of CHF 98.77 million. Swiss taxes withheld of CHF 34.57 million were refunded by the SFTA upon the bank's request. In 2007, the Danish bank received dividends of CHF 66.86 million, from which approx. CHF 26.4 million in Swiss withholding taxes (35%) were deducted and reclaimed by the Danish bank. The SFTA denied the refund request for 2007 and eventually raised a repayment claim for the 2006 withholding taxes that had already been refunded. The SFTA took the position that the bank was not the beneficial owner of the dividends and had abused the tax treaty.

In the administrative proceeding, the Danish bank maintained that its main activity was trading in share index-based futures and in American depository rights (ADRs) on shares; the futures would often be used for financial arbitrage transactions. Upon maturity of the futures (which was typically after three months), either they would be closed and the underlying shares would be sold, or the futures would be "rolled" into new, similar contracts and the underlying shares would be kept. The Danish bank emphasized that it did not enter into any bilateral arrangements with its futures counterparties with regard to the underlying SMI Index shares. The SMI Index purchase and sale transactions were concluded with a broker that acted in its own name, while the futures transactions were made via another broker through the Eurex Exchange.

The SFTA took the view that both transaction types were to be classified as over-the-counter (OTC) transactions or block trades. The SFTA concluded that, in view of the enormous transaction volumes and the proximity of the SMI index purchase dates to the dividend payment dates, the transactions were "highly unusual" and must have required mutual knowledge of the counterparties and specific

14. Consideration 8.6, second para.

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arrangements between them. The SFTA further noted that the Danish bank was not exposed to any share price fluctuation risks; the net profit for the Danish bank from the arrangements was clearly defined from the outset. In addition, the SFTA emphasized that this net profit represented only a small percentage of the gross dividends received, while the bulk of the dividend benefits was passed on to non-Danish resident parties under the arrangements. Overall, the SFTA determined that the transactions were motivated mainly by the location benefit of the Danish bank, which promised a full refund of the Swiss withholding taxes. The SFTA concluded that the Danish bank lacked beneficial ownership of the dividends and abused the tax treaty in question.

4.2. Considerations of the FAC[15]

On appeal by the Danish bank, the FAC first emphasized that a refund of Swiss withholding taxes to a non-resident person (such as the Danish bank) may not be based on the Federal Withholding Tax Act;[16] the sole basis for any such relief must be found in a income tax treaty applicable to the non-resident claimant. Treaty law takes precedence over the Withholding Tax Act, as far as relief from withholding tax is concerned. The Court referred to article 10 of the former tax treaty with Denmark in conjunction with the Swiss implementing Ordinance, article 1, under which full relief from withholding tax pursuant to the treaty is implemented on the Swiss side by a subsequent refund procedure for the tax initially withheld pursuant to Swiss domestic rules.

The FAC further pointed to the fact that the tax treaty in question did not explicitly include any “beneficial owner” language as a condition for tax treaty benefits. The former treaty with Denmark, concluded in 1973, largely followed the 1963 OECD Model, which did not explicitly stipulate any beneficial owner requirement, either. The Court reiterated the Swiss jurisprudence, according to which provisions in Swiss tax treaties must typically be interpreted based on their wording and the general meaning thereof. Such meaning must be determined in light of the context and the objectives pursued by the treaty in accordance with the principle of good faith, i.e. in accordance with the Vienna Convention on the Law of Treaties, in particular article 31. According to Swiss doctrine and jurisprudence, where a tax treaty is based on the OECD Model, the provisions and the Commentary on the OECD Model play an important role in the interpretation of the actual tax treaty, even though the provisions of the OECD Model and the Commentary thereon remain subject to the general interpretation rules of article 31 et seq. of the Vienna Convention. Therefore, the OECD provisions and commentaries, although being important, do not effectively bind either the Swiss courts or taxpayers.

The FAC made reference to a doctrine, which is asserted by a number of Swiss scholars and was adopted by a 2005 decision of the FAC’s predecessor under the same former Denmark treaty, according to which the beneficial owner requirement is inherent in all Swiss income tax treaties, even if it is not explicitly mentioned in the text of the particular treaty. However, the Court refrained from deciding on this fundamental point, noting a controversy in the Swiss legal doctrine regarding whether subsequent versions of the OECD Model and the Commentary thereon should be taken into account for the interpretation of a tax treaty that is still based on an earlier version of those documents.

Nonetheless, the FAC went on to analyse the beneficial owner concept. The Court emphasized that beneficial ownership serves to determine the *intensity of the relationship between a taxpayer and the taxable object from an economic perspective (substance-over-form approach)*. The relevant criterion is the degree of the taxpayer’s discretion to decide on the application of the income. Mere fiduciaries or agents should be excluded from the treaty benefits. Thus:

> If one person is obliged to pass on income to another, this shows that the first person’s power to decide on the use of that income is limited. If the obligation to pass on income is contractual, this may speak against the classification as beneficial owner. Further, a merely factual duty to pass on income may limit the power to decide on the use of that income to such a degree that the person concerned can no longer be considered the beneficial owner. The stronger the mutual or reciprocal dependence or interdependence between the income and the duty to pass it on, the weaker the power to decide on its use. The key issue is the degree to which generating income is dependent on the obligation to pass it on. Besides that, the degree to which the obligation to pass on income is dependent on the generation of that income is to be considered. Moreover, a possible indication of beneficial ownership is the assumption of the risks associated with the income. Relevant in this context is, in particular, the questions as to who bears the risk in case no dividend is paid. With regard to timing, an assessment of beneficial ownership must be made at the time the income has arisen. Therefore, the fact of a very brief holding period does not preclude beneficial ownership. Furthermore, the concept of beneficial ownership disregards subjective factors, such as any intention of abuse. The reasons for choosing a particular structure are thus irrelevant to the question of beneficial ownership.[17]

The FAC eventually reached the conclusion that the application of Baumgartner’s theory of mutual dependence between the receipt of the dividend income and the payment obligations arising under the futures contracts, supported the result that such a mutual dependency was not deemed to exist. Accordingly, the Danish bank had to be regarded as the beneficial owner of the dividends in question. The Court determined that the Danish bank was exposed to the dividend and financing risks, and had the discretion to decide on how to apply the dividends received. Therefore, according to the Court, the Danish bank was under no de facto obligation to pass on the dividend benefits.

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15. FAC ruling A-1246/2011 (23 July 2012).

16. Federal Act on Withholding Tax of 13 Oct. 1965 (*Bundesgesetz über die Verrechnungssteuer vom 13 Oktober 1965*), SR 642.21 together with related ordinances, regulations and guidelines, all as amended.

17. Consideration 4.3.2.

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Even though it was established as a fact that the purchases of the shares by the Danish bank had been financed by loans of the Swedish parent company, the Court found that it was not proven that the dividends were needed to pay the interest on the loans.

In addition, the loan interest would have been payable even in the absence of the dividend receipts. According to the Court's findings, it was not evident that the Danish bank was obliged to hedge the payment obligations arising under the futures contracts by acquiring the underlying Swiss shares.

Further, the Court found that there were no concrete indications of any circular arrangements. A circular arrangement would have meant that the ultimate sellers of the shares and the ultimate buyers of the futures contracts were the same persons. Finally, similar to the swaps case, the Court determined that the Danish bank had substance (an office, employees and sufficient trading infrastructure) at its disposal and was carrying out an active trading activity in Denmark, which meant that the issue of tax treaty abuse was out of question.

4.3. Decision of the Supreme Court[18]

Similar to the swaps case, upon appeal lodged by the SFTA, the Supreme Court reversed the decision of the FAC in favour of the SFTA.

First, the Supreme Court affirmed its approach that beneficial ownership is a condition precedent for tax treaty benefits, inherent in all Swiss tax treaties, even if not stated explicitly in a particular treaty.

Similar to the FAC, the Supreme Court considered that the relevant criterion for beneficial ownership is the intensity of the relation between a taxpayer and an item of taxable revenue based on the degree of decision powers over the application of the revenue. This is to be measured by the degree of economic control and effectively exercised powers, applying a substance-over-form approach. The beneficial owner concept is meant to prevent the insertion of persons with only limited decision powers for the purpose of availing the benefits of a tax treaty. A contractual obligation or a merely factual restriction leading to a duty to pass on the income existing at the time the income arises removes the beneficial owner quality. A relevant restriction must be assumed when two conditions are met, namely (i) the receipt of items of income depends on the obligation to pass them on and (ii) the obligation to pass on the income depends on the actual receipt thereof.

In the case at hand, the Supreme Court analysed the beneficial ownership mainly from a cash flow perspective. The Court determined that the claimant would have retained a net profit from the first series of hedged futures transactions of approximately 9% of the gross dividends, or 0.04% of the entire transaction value. In the second series of transactions, the net profit would have corresponded to approximately 6.6% of the gross dividends or approximately 0.08% of the transaction volume. The Court concluded that the low percentage of net retained dividends meant that "a harmful passing-on could not be excluded" and clarified that beneficial ownership would be excluded not only when all of the relevant income was passed on, but also when this is the case for the predominant portion of the income.

The Supreme Court went on to test whether the interest payments to the claimant's Swedish parent bank amounted to a "harmful passing-on". The Court pointed to a number of "suspicious factors" that had been raised by the SFTA: The entire funding came from one financier, which happened to be the Swedish parent bank. According to the Court, this raises a question as to what extent the claimant was in a position to act independently. The Court emphasized that the Swedish parent would not have been entitled to full withholding tax relief, but would have been exposed at least to a 15% residual Swiss withholding tax under the applicable tax treaty. The Court appears to share the opinion of the SFTA that this alone could indicate that the Danish bank carried out the relevant transactions on behalf of its Swedish parent, in order to avail the treaty benefits. The Court pointed further to inconsistent information given by the Danish bank regarding the amounts of interest paid to the Swedish parent and concluded that the Danish bank had breached its procedural duty of cooperation. Although this breach alone would not have led to the denial of treaty benefits, the Court assumed that, based on the indicia asserted by the SFTA, at least parts of the dividends received were passed on to the Swedish parent bank.

Furthermore, the Supreme Court fully supported the SFTA's pointing to additional "suspicious, extraordinary elements" of the transactions:

- the Danish bank had sold SMI futures with a total volume of approximately CHF 3.7 billion on one single day, which exceeded the average daily trading volume of the entire exchange (CHF 2.7 billion).[19] The Court shared the view of the FTA that a transaction of such a magnitude necessitates that the parties know each other and make clear agreements. The Court found that "this transaction would not have been entered into in the same fashion among independent third parties, especially in terms of the price conditions";[20]
- the net profit to be realized from the share transactions was already known when the transactions were agreed upon. "The profit was not the result of open market considerations, but rather of the specific agreements among counterparties known to each other".[21] The Court cited the assertion by the SFTA that "the fact that X Bank utilized two different brokers and two different exchanges does not exclude that two parties agreed to enter matching stock orders into the system at different points in time shortly before and shortly after the dividend dates in a mutually coordinated fashion, in order to keep external anonymity and to generate the impression of transactions between independent third parties, even though the transaction effectively occurred between parties that knew each other".[22] The Court clarified that a coordinated arrangement was made primarily with the broker used (inserted) for the stock transactions. The

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18. **Supreme Court decision 2C_895/2012 (5 May 2015).**
19. Consideration 8.1.
20. Consideration 8.1.1.
21. Consideration 8.1.2.
22. Consideration 8.1.2, second sentence.

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authors note that the line of argument adopted by the SFTA and supported by the Supreme Court was based essentially on mere assumptions and suspicions (indicia). No evidence of the alleged coordinated, bilateral behaviour was presented;

- the "short time intervals" between the purchase of the SMI securities (on 19 February 2007), the dividend dates of the relevant securities (between 9 March and 22 May 2007) and the resale of the securities on 15 June 2007, as well as the fact that only one broker was used for the share transactions and another broker was used for the futures trades – both on the way in (on 19 February 2007) and on the way out (on 15 June 2007) – were classified as a further "suspicious element".[23] The Danish bank had stated that the broker for the share trades had acted as a principal, not just as an intermediary or agent. The Court noted that the broker was resident in the United Kingdom and would thus have been exposed to a residual dividend withholding tax of 15% under the Swiss tax treaty with the United Kingdom. The broker purchased the shares from other parties for its own trading stock prior to selling them to the Danish bank, and it acted similarly when it purchased the shares back from the Danish bank and sold them on to other parties;
- accordingly, the Supreme Court agreed with the conclusion of the SFTA that the share purchase transactions on 19 February 2007 and the stock sale transactions on 15 June 2007 agreed upon between the Danish Bank and the UK resident stock broker constituted a "circular transaction" between counterparties known to each other.[24] The transactions were entered into the trading system of the stock exchange as "OTC-type block trades". The Court emphasized that the transactions constituted individually negotiated single, bilateral transactions of a very large volume between the Danish bank and a broker with which it traded frequently, whereby especially the prices were negotiated bilaterally in a manner allowing for the passing-on to the broker of the entire portion of the dividends that was not retained by the Danish bank;
- moreover, the Court supported the assertion of the SFTA that the same bilateral terms of the share trades between the Danish bank and the stock broker were extended to its counterparties by the latter. During the administrative proceeding, the Danish bank revealed that the stock broker had dealt with eight, not specifically named counterparties from three jurisdictions (Sweden, the United States and the Netherlands). The SFTA concluded that it was suspicious that the shares were eventually sold back into the same three jurisdictions to only eight counterparties, which were all exposed to a 15% residual Swiss withholding tax burden. The SFTA concluded further that an abusive dividend stripping had been arranged for the benefit of those eight counterparties, in order to avail them the benefits of the Denmark-Switzerland Income and Capital Tax Treaty (1973) to which they were not entitled;
- the Supreme Court criticized the FAC for not having considered the dividend stripping based on circular transactions.[25] The Supreme Court emphasized that the bilateral transactions between the Danish bank and the stock broker were already circular. It would be reasonable to assume that the same was true for the ensuing transactions between the broker and its eight customers;
- the Supreme Court also criticized that the FAC based its decision on only the information that the Danish bank had been prepared to disclose.[26] In that context, the Supreme Court determined a *breach of the Danish bank's information and cooperation duties*.[27] The Supreme Court considered the questions of the SFTA about the identities of the stock broker's customers to be essential for the analysis of the "entire construction" of the transactions implemented by the Danish bank, especially with regard to the terms of the undertakings to pass on the received dividends to the broker and beyond to the broker's customers;
- the Supreme Court rejected the Danish bank's argument that it was unable to disclose the identities of the broker's customers, as the broker itself was barred from giving such disclosure under professional secrecy rules.[28] The Court referred to its own jurisprudence, according to which such confidentiality obligations of third parties do not always relieve the taxpayer from its own information and cooperation duties. The Court found that the SFTA had brought forward enough indicia allowing for the assumption that the transactions under review constituted circular transactions also with regard to the broker's undisclosed customers. "The arrangements made could result in a systematic unjustified claiming of the specific benefits of article 10 DTT-DK under the given circumstances. *The actual design of the relevant transactions had the effect that the Claimant caused a particular need of investigation, in view of which it could not simply and generally rely on the professional secrecy of the broker that it had engaged*".[29] The Supreme Court even held that "the non-disclosure of the counterparties of the broker Y was an intentional and crucial element of the entire construct of the transactions". The Court thereby implied that the additional cost of using a broker for the large volume trades was incurred explicitly in order to secure the benefit of anonymity, which was provided by the broker's professional secrecy obligation; and
- the Supreme Court accused the Danish bank of having created an "investigative emergency" with regard to essential elements of the transactions under review, by invoking the secrecy obligations of the stock broker. The Court held that the Danish Bank could not take any benefits from the self-created uncertainty with regard to essential facts. Therefore, the Court felt it could rely on the indicia brought forward by the SFTA.

Finally, the Supreme Court had another look at the financial parameters of the transactions.[30] Essentially, the Supreme Court found that the counterparties – via the inserted broker – paid only CHF 22 million less for the final repurchase of the shares than they had

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23. Consideration 8.2.1.
24. Consideration 8.2.2.
25. Consideration 8.3.2.
26. Consideration 8.3.2, second para.
27. Consideration 8.3.3.
28. Consideration 8.3.3, fourth to sixth paras.
29. Consideration 8.3.3, fifth para.
30. Consideration 8.4.3, second to fourth paras.

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initially received from the sale of the shares to the Danish bank (via the same broker). At the same time, however, the counterparties were foregoing more than CHF 72 million in (gross) dividends – which would have implied a substantial net loss overall. In the Supreme Court's analysis, the transactions became plausible only because the counterparties would eventually have received back most of the dividends – including the full withholding tax refund benefit – via the futures transactions. It is not clear on what basis the Supreme Court actually reached that conclusion. The authors must assume that the conclusion is ultimately based on the Court's fundamental assumption that the combination of share purchase and sale transactions and the futures transactions was effectively made between the same effective counterparties – the Danish bank and the eight undisclosed customers of the stock broker and constituted a circular transaction, mainly designed to transfer the withholding tax refund benefit to those ultimate counterparties.

Rather lengthy, slightly confusing and repetitive considerations led the Supreme Court to the overall conclusion[31] that the Danish bank held the shares only for a rather short period of a few months, during which the dividends arose on the shares, whereas the bank had been merely inserted as a formal owner of the shares under a circular "transaction construct" including financing and hedging elements, with the objective of cashing in the dividends on the Swiss shares and passing them on to the former and ultimate real owners of the shares, whilst securing full refunds of the Swiss withholding tax. The Supreme Court found that the Danish bank did not bear any notable risks and concluded that the bank effectively was obliged to pass on only those dividends that it actually received. In the end, the Supreme Court concluded[32] with a three-two majority of the sitting judges that both dependencies, under Baumgartner's theory, were present, and accordingly the Danish bank did not hold beneficial ownership. This led to a dismissal of the Danish bank's pending withholding tax reclaims and a confirmation of the claw-back reclaims by the SFTA based on the same reasoning as adopted in the swaps case. Given this outcome, the Supreme Court did not need to review the aspect of tax treaty abuse.[33]

Finally, the Supreme Court confirmed the SFTA's claim for repayment of already refunded withholding taxes of prior years, essentially based on the same considerations[34] as adopted in the total return swaps case (*see* section 2.).

5. Comments

The two decisions that are the focus of this article were designated by the Supreme Court as "leading cases" in subsequent rulings that did not exactly concern the same tax issues. Although the grounds on which these decisions were reached appear to be mostly driven by the individual fact patterns of each case – including some remaining uncertainties surrounding the facts, which could be blamed on the claimants – it is rather obvious that the SFTA will use these rulings as significant precedents for many contested cases of tax-treaty-based withholding tax refund requests which are still pending.

One of the key takeaways from the decisions is the fundamental significance of the beneficial owner notion given by the Swiss courts to the interpretation of Swiss tax treaties. Beneficial ownership of the income is understood as an explicit or implied condition precedent to tax treaty benefits, in particular with regard to relief from source country taxation of dividends, interest and royalties, even where the tax treaty in question does not explicitly state that condition. Therefore, beneficial ownership is examined before any analysis of tax treaty abuse is undertaken.

The Supreme Court determines beneficial ownership of income based on the intensity of the relation between the claimant of tax treaty benefits and the income for which the benefits are sought, at the time the income arises. The main criterion used is the degree of the income recipient's power to decide on the application of the income. The degree of independent decision power is tested based on legal and factual indicia, and in this regard the Supreme Court generally adopts a substance-over-form approach. The assumption of economic risks with regard to the income may serve as a further criterion. Where it appears that the income recipient, in fact, passes on the income (or a very substantial portion thereof) to a third party, the Supreme Court basically adopts the theory of mutual dependency developed by Baumgartner – beneficial ownership is removed if the receipt of the income is dependent on the legal or "factual" obligation to pass the income on to a third party in whatever form, and the obligation to pass on is contingent on the receipt of the income.

As the two cases of obligations arising under derivative financial instruments in conjunction with the receipt of dividends on shares underlying the derivatives have demonstrated, the crux – in practice – lies in the interpretation of the obligations or restrictions arising under the derivative strategies with regard to the application of the income that arises on the underlying securities, which are typically acquired and held by the issuer or seller of the financial derivative to cover (hedge) the financial exposure arising under the derivative. The key question to be decided by the Swiss courts when applying the theory of "mutual dependence" to combinations of financial derivatives with the underlying securities – whereby typically a dividend (or interest) payment arises from the securities during the term of the arrangement – concerns whether the receipt of the (dividend or interest) income and the passing-on of (most of) the income to the derivative counterparty, depend on each other. In other words, the question concerns:

- whether the (formal) holder of the securities would have received the income even in the absence of the obligations arising under the financial derivative (the Supreme Court appears to slightly modify the question into whether the income-generating securities would have been acquired to begin with, in the absence of the simultaneous entry into the financial derivative); *and*

31. Consideration 8.5.
32. *See* considerations 9 and 10.
33. Consideration 10 *in fine*.
34. *See* consideration 11.

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- whether the obligations under the derivative would have persisted even in the absence of the receipt of the income on the underlying security (or, in the modified version of the Supreme Court, whether the derivative would have been entered into without the parallel acquisition of the underlying securities).

The FAC followed more closely the approach adopted by the originator of the theory of mutual dependency and concluded in both cases, based on the concrete facts at hand, that the receipt of the dividends by the Danish banks and the payment profile arising under the total return swaps or the exchange-traded index futures, respectively, were not dependent on each other. The FAC found that the physical long positions in the shares and the derivative short positions under the swaps or futures could have been entered into independently; the Danish banks were not obliged to cover (hedge) their payment profile or obligations arising under the derivatives by acquiring the underlying shares and receiving the dividends, and they were not obliged to enter into the derivatives as a condition for the acquisition of the shares and the receipt of the dividends.

However, the Supreme Court interpreted the facts completely differently. The Court effectively emphasized the factual nexus and time coincidence between the acquisition and (relatively short) holding period of the shares, during which the dividends in question arose, and the derivative short positions, from which the Supreme Court effectively drew the conclusion that this was not coincidental, but rather reflected the intention of the Danish banks to systematically receive the Swiss dividends, exploit the particular tax treaty benefits (the former Swiss tax treaty with Denmark was rather unique, as it provided a full dividend withholding tax relief for all residents of either contracting state) and pass on the bulk of those benefits to other parties that would not have been entitled to equivalent withholding tax relief. The Supreme Court used further indicia to support its fundamental conclusion with regard to the facts and the lacking beneficial ownership of the Danish bank claimants. Those indicia included:

- the large volume of the transactions and size of the positions;
- the significant debt funding of the share positions by the Swedish parent bank in the futures case;
- the use of the same brokers for the initial build-up and the final dissolution of the shares positions;
- the fact that the claimants were either unable or unwilling to disclose the identity of the broker’s customers on the other side of the trades;
- the factual finding that the brokers were acting for only a small number of customers that were neither Swiss nor Danish resident; and
- the rather small net profit margins derived by the Danish banks from the trades (in terms of percentage of the gross dividends and net return on the amounts invested), in conjunction with the relatively low risk profile for the Danish banks (in particular, the absence of any share price fluctuation risks), which – in the view of the SFTA and the Supreme Court – indicated that the Danish banks’ economic position was similar to that of a mere agent or fiduciary, acting for the (economic) benefit of third parties that would not have been eligible for tax treaty benefits and earning merely a service fee compensation.

The combination of all these factors led the Supreme Court to the conclusion (in terms of an *assumption of fact*, even though there was no hard evidence) that the transactions must have been circular, pre-arranged among a small group of parties that knew each other and had specific agreements with one another, i.e. amounted to abusive dividend stripping schemes in favour of undisclosed foreign parties, which were and remained the economic owners of the shares throughout and would not have been entitled to equivalent relief from Swiss withholding taxes on the dividends, the benefits of which they received via the financial derivatives.

The authors generally find that the significance of these two decisions of the Supreme Court as leading cases on beneficial ownership, should not be overstated. The decisions were very much driven by the specific, individual fact patterns and remaining uncertainties with regard to some of the facts considered relevant, which could be blamed on the claimants’ insufficient compliance with information obligations and procedural cooperation with the competent tax authority. Indeed, the decisions could be seen as typical examples of “bad cases make bad law”.

The authors also have the impression that the decisions to deny the tax treaty benefits, although officially based on the denial of the Danish banks’ beneficial ownership of the Swiss dividends in question, were effectively driven by strong anti-abuse considerations, in particular a perception on the part of the SFTA and a majority of the Supreme Court judges that some particular features of the former Swiss tax treaty with Denmark – in particular, the 0% treaty withholding tax rate on dividends available to all residents of the treaty partner state, combined with the lack of specific beneficial owner or anti-abuse language – was prone to abuse, by, for example, sophisticated international financial players. Notably, however, the Supreme Court refrained from considering these cases under the aspect of abuse of tax treaty rights and focused only on the beneficial owner issue – which it ultimately had to decide based on mere indicia and factual assumptions. The perceived “lack of sufficient cooperation” by the foreign claimants with the SFTA in the process of establishing the relevant facts played an important role.

It will be interesting to observe further development of Swiss case law on withholding tax relief with regard to positions in Swiss shares (or bonds) that are held in connection with all different kinds of financial derivatives, whereby the securities typically provide a hedge (or cover) for the obligations arising under the derivative, whilst the derivative acts as a hedge against the market risk associated with the holding of the security position. Not all of the numerous still pending cases concern a potential 0% net withholding tax environment, and the dividend (or bond interest) component priced into the derivatives will not in all cases correspond to 100% (or very close to 100%) of the original gross dividend (or interest) arising on the underlying security. Furthermore, not all of those cases may provide clear indicia for

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pre-arranged circular transaction schemes for small groups of ultimate beneficiaries. Some of the pending situations may feature much longer holding periods of the securities that generate the income from which Swiss withholding tax must be deducted.

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