Switzerland

Swiss Pension Fund Entitled To Reclaim Swiss Withholding Tax on Dividends Received Indirectly via Irish Investment Fund

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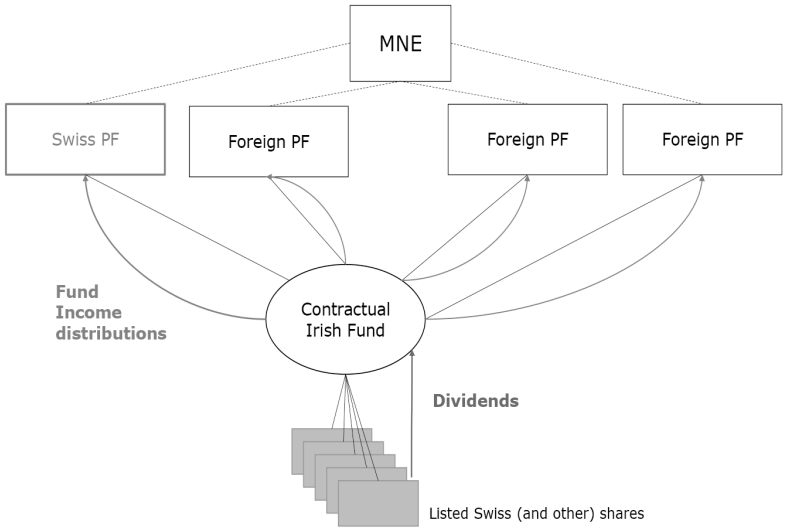
The Federal Supreme Court has ruled that a Swiss regulated and tax-exempt pension fund is entitled to reclaim Swiss federal withholding tax deducted from dividends on publicly traded shares of Swiss companies received indirectly via an Irish contractual investment fund.

1. Introduction

In a recent decision, the Federal Supreme Court (Supreme Court) ruled that a Swiss regulated and tax-exempt pension fund is entitled to reclaim Swiss federal withholding tax deducted from dividends on publicly traded shares of Swiss companies.[1] The pension fund had invested in these shares only indirectly, via an Irish contractual fund acting as an investment vehicle for several local pension funds of a multinational enterprise. The relevant structure can be illustrated as follows:



The Supreme Court reasoned that the Irish investment fund was comparable to a Swiss contractual fund, treated as a fiscally transparent entity for Irish tax purposes and thus had to be treated as fiscally transparent for purposes of the Swiss income tax treaty with Ireland and of the Federal Withholding Tax Act, as well. Accordingly, the Supreme Court concluded that the Swiss pension fund had to be recognized as the ultimate beneficial owner of the dividends derived through the transparent Irish fund. Furthermore, the Supreme Court held that in the case at hand, the Swiss pension fund had sufficiently accounted for the income.

2. The Case

2.1. Relevant facts

On 15 September 2016 the Federal Supreme Court (*Tribunal Fédéral*) rendered a noteworthy decision regarding the entitlement of a Swiss regulated and tax-exempt pension fund (the Swiss pension fund) to claim refunds of Swiss withholding taxes deducted from dividends paid on Swiss listed shares. The shares were held indirectly by the pension fund through an Irish regulated, fiscally transparent, contractual investment fund (Irish Fund). The Federal Supreme Court dismissed an appeal brought by the Swiss Federal Tax Administration (SFTA)

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1. CH: TF, 15 Sept. 2016, 2C-404/2015.

against a ruling by the lower court (the Federal Administrative Court) which had decided in favour of the Swiss pension fund, confirming the Swiss pension fund's entitlement to Swiss withholding tax refunds on the dividends received via the Irish Fund.

The Swiss pension fund had approached the SFTA in April 2004 with a request for an advance tax ruling with regard to intended indirect investments in Swiss publicly traded shares through the Irish Fund, which was to be set up as a "Common Contractual Fund". The Irish Fund would act as a special form of contractual investment fund on behalf of international pension institutions. In fact, the Irish Fund would have five to six investors that were all qualifying pension funds from different jurisdictions, including the Swiss pension fund, for the personnel of a multinational enterprise.

The Irish Fund would be managed by a separate fund manager and use its own depositary bank. In the tax ruling, the SFTA had agreed that:

- the Irish Fund would be treated as a fiscally transparent vehicle for Swiss tax purposes and for the purposes of application of Swiss income tax treaties;
- the Swiss resident investor in the Irish Fund (the Swiss pension fund) would be treated with regard to the income or distributions, respectively of the Irish Fund, as if it had made the investments in the underlying securities directly (thus, the Swiss pension fund should not suffer any fiscal disadvantages through the indirect investment via the Irish Fund with regard to Swiss federal withholding tax or under any applicable tax treaty); and
- foreign resident investors in the Irish Fund are entitled to claim the benefits of the tax treaty between Switzerland and the residence country of the foreign investor in the Irish Fund, as if such foreign investor had invested directly in the underlying Swiss securities.

The depositary bank of the Irish Fund filed various Swiss withholding tax reclaims on Form 25 to the SFTA on behalf of the Swiss pension fund with respect to dividend withholding tax suffered from 2006 to 2009. The reclaim forms were signed by the global custodian of the Irish Fund which always indicated the Swiss pension fund as the "full beneficial owner". Initially, the SFTA approved the withholding tax reclaims for a total amount of close to CHF 22 million.

In July 2010, the SFTA carried out an audit of the accounts of the Swiss pension fund with regard to the Swiss withholding tax refunded for the years 2007 to 2009. The SFTA determined that the Irish Fund consisted of three subfunds, which applied the "look-through method". The tax ruling had specified that, notwithstanding the fact that the Swiss securities in question were immediately held by the subfunds, Swiss withholding tax could be reclaimed by the ultimate effective beneficiaries (such as the Swiss pension fund). The SFTA further determined that the Irish Fund was a regulated investment fund in Ireland, which for purposes of refunds of Swiss withholding tax *and* Swiss stamp duties on the transfer of securities could *not* be considered as fiscally transparent. Therefore, the SFTA concluded that the withholding tax refunds made to the Swiss pension fund were not justified and had to be returned. In the course of the further administrative proceeding, the Swiss pension fund repaid some CHF 1.2 million in withholding tax refunds already received without prejudice, in order to prevent possible late payment interest charges.

Eventually, the SFTA rendered a formal decision in August 2011, rejecting the withholding tax reclaims of the Swiss pension fund for the years 2006 to 2010 for approximately CHF 1.6 million and further demanded payment of late payment interest of 5% per annum for the period between the "unjustified" withholding tax refunds and the day of repayment by the Swiss pension fund. The essential reasons stated by the SFTA included the lack of "ordinary accounting" for the dividend income in question. The SFTA maintained that the tax ruling stated only the person that could claim refunds of withholding tax *in principle*; however the ruling did not say anything about the actual entitlement to such withholding tax refunds. The SFTA maintained that all conditions precedent for refunds of withholding tax, in particular the requirement of "ordinary accounting" in accordance with article 25 of the Withholding Tax Act (WHT Act), would have to be met for a refund.

The Swiss pension fund filed a written objection against the decision of the SFTA, which the SFTA rejected by decision of 11 January 2013. In that second decision, the SFTA concluded that the Swiss pension fund was not the beneficial owner and did not "ordinarily account" for the Swiss dividends in question, and hence failed to comply with article 25 of the WHT Act. Moreover, the tax ruling could not be relied upon, as it only included statements about the identity of the person entitled to claim withholding tax refunds, but not with respect to the other conditions for such refunds.

2.2. Appeal

The Swiss pension fund appealed to the Federal Administrative Court (*Tribunal Administratif Fédéral*), which upheld the appeal by judgment of 26 March 2015. The Federal Administrative Court confirmed the beneficial ownership of the Swiss pension fund and considered the accounting for the dividends in question as being in line with the requirements posed by article 25 of the WHT Act.

The SFTA formed an appeal in public law to the Federal Supreme Court against the decision of the Federal Administrative Court, requesting the confirmation of its own decision to reject the withholding tax reclaims by the Swiss pension fund. The SFTA specifically took the position that article 26 of the WHT Act allocated beneficial ownership to the collective investment fund "for tax technical reasons", wherefore the Swiss pension fund was not beneficially entitled to the income *e contrario*. However, as in the case at hand, a tax ruling existed which, in principle, allocated an entitlement to withholding tax refunds to the Swiss pension fund. A review had to be undertaken into the question as to whether the dividend income in question had been "ordinarily accounted for". The SFTA concluded that this was

not the case and, accordingly, the judgment of the Federal Administrative Court violated articles 25 and 26 of the WHT Act and had to be reversed.

2.3. Considerations of the Supreme Court

The Supreme Court reiterated the general conditions applicable to withholding tax reclaims made by resident legal entities, namely:

- the legal seat is in Switzerland;
- there has been ordinary accounting for the income that suffered deduction of withholding tax as income;[2]
- the entity has beneficial ownership of the assets that gave rise to the taxable income as of the due date of such income;[3]
- the withholding tax refund request is filed within three years after the end of the calendar year in which the relevant income fell due;[4] and
- refunds of withholding tax are excluded in any case that would allow for tax avoidance to occur.[5]

The Supreme Court pointed to the special rule of article 26 of the WHT Act, which applies only to Swiss collective investment schemes (funds) that deduct and remit Swiss withholding tax from the taxable returns distributed on their own shares. Such Swiss collective investment schemes are entitled to refunds of withholding tax deducted from returns on behalf of the collective investment scheme. Article 24 of the WHT Act applies by analogy. This means essentially that a transparent Swiss investment fund that deducts and remits 35% withholding tax from its income distributions made to the fund investors is entitled to claim withholding tax refunds in its own name for withholding tax charged to the fund on the Swiss investments made by the fund on behalf of the investors.

The Supreme Court pointed to the predominant purpose of Swiss withholding tax to secure compliance with income tax obligations by *Swiss resident* beneficiaries, whereas withholding tax deducted from Swiss income of *non-Swiss resident* beneficiaries has a direct fiscal purpose.

The Supreme Court classified the Irish Fund as an open-ended foreign collective investment scheme, which is characterized by the fact that the investors do not have any entitlement towards the fund to have their fund shares redeemed at their net asset value.[6] The classification was not under dispute; however disputed was the fulfilment of further conditions precedent for withholding tax refunds, in particular, whether the income in question was “properly accounted for”, and whether the Swiss pension fund was the beneficial owner of the underlying Swiss shares.

The Supreme Court then addressed the fiscal transparency of collective investment schemes, which is given when the scheme is not treated as a separate taxpayer and the taxable income items are directly attributed to the fund investors, for income tax purposes. Contractual funds are generally treated as transparent. However, as regards the *collection* of withholding tax, such (Swiss) funds are opaque: the fund or its management must apply withholding tax to its income distributions to the investors. This led the Supreme Court to examine whether such foreign funds should also be treated as opaque vehicles with regard to Swiss withholding tax refunds. The Court determined that the fund in question was an Irish fund vehicle. The Court proposed a “pragmatic mix of approaches” for cases where the applicable foreign civil/commercial law does not recognize a separate corporate legal personality of the entity in question: the foreign entity is to be compared with similar Swiss entities, and the foreign tax treatment is to be considered, as well. The Court determined that the Irish fund was treated as a look-through entity for Irish tax purposes and that the tax ruling also provided for a transparent tax treatment for purposes of the Ireland-Switzerland Income and Capital Tax Treaty (1966).

In addition, the Supreme Court considered that article 26 of the WHT Act (providing for a separate entitlement of *Swiss* funds to reclaim withholding tax charged to the fund on its Swiss investments) applies only to Swiss funds in order to prevent dual charges of withholding tax and does not alter the fact that the (Swiss or foreign) fund does not have separate legal personality and thus is not a separate taxpayer. Finally, the Supreme Court referred to the previous practice of the SFTA, according to which foreign investment funds were to be considered *transparent* vehicles for purposes of reclaiming Swiss withholding tax. Swiss income tax treaties would thus not be applicable to the foreign fund vehicle. Rather, the beneficial ownership of the Swiss income in question (derived immediately by the foreign fund vehicle) would be allocated directly to the (domestic) investors in the foreign fund. The Court pointed once again to the protection of the taxpayer’s good faith under the tax ruling, the transparent tax treatment of the Irish Fund in Ireland and to the general Swiss tax approach towards contractual investment funds (i.e. fiscal transparency). It concluded that, for purposes of reclaiming Swiss withholding tax on the Swiss investment income arising in the Irish Fund, the principle of transparency is to prevail.

Therefore, the Supreme Court had to determine whether the Swiss pension fund (as investor in the transparent Irish Fund) fulfilled the withholding tax reclaim conditions under applicable Swiss law, first of all, beneficial ownership of the assets that generated the taxable income in question.[7] The Court briefly discussed the general features of beneficial ownership (in German terminology, the “right to use”

2. Art. 25(1) WHT Act *e contrario*.
3. Art. 21(1)(a) WHT Act.
4. Art. 32(1) WHT Act *e contrario*.
5. Art. 21(2) WHT Act.
6. Art. 119(2) Collective Investment Scheme Act (CISA).
7. Art. 21(1)(a) WHT Act.

the asset and to enjoy the income generated by the asset) and went on to reject the theory of the SFTA, according to which the special rule of article 26 of the WHT Act also extended to beneficial ownership (of the collective investment vehicle, instead of the fund investors). The Supreme Court held that article 26 was not relevant to the case at hand; the provision deals only with *Swiss* investment funds and their particular entitlement to withholding tax reclaims, while withholding tax refunds in a cross-border context are exclusively regulated by the applicable Swiss income tax treaty. Even though Switzerland has agreed with a few countries on a special entitlement to treaty benefits of collective investment schemes established in the other tax treaty jurisdiction on behalf of their investors who reside in the same jurisdiction, Ireland is not among those treaty jurisdictions. *The Court considered the transparent tax treatment of the Irish Fund in Ireland to be decisive for the transparent treatment for Swiss withholding tax reclaiming purposes, as well*. The Irish Fund had to be "looked through" with regard to the Swiss dividends indirectly derived by the Swiss pension fund via the Irish Fund. From that perspective, the Court directly acknowledged the beneficial ownership of the Swiss pension fund, as the Swiss pension fund had the right to ultimately receive and enjoy that income. The Court held the theory that article 26 of the WHT Act extended to the beneficial owner aspect to be incompatible with the transparency principle.

The SFTA had argued further that the Irish Fund did not establish any trustee or fiduciary arrangement worthy of recognition for Swiss tax purposes, as the relevant conditions pursuant to a published guidance note by the SFTA were not fulfilled (in particular, no written instrument settling a trust or fiduciary arrangement, no purchase and sale documents for the shares in the records of the Swiss pension fund, no designation of the shares as assets held in trust in the accounts of the Irish Fund). The Supreme Court dismissed that formal argument, as well, pointing to the clear beneficial ownership ("effective right to use") of the Swiss pension fund with regard to the Swiss shares held through the transparent Irish Fund. The Court confirmed the rule that the principle of transparency applicable to fiscally transparent foreign collective investment schemes dictates the allocation of beneficial ownership to the investors in such an investment scheme. Accordingly, the Court concluded that a Swiss resident investor (such as the Swiss pension fund) in a foreign collective investment scheme has a proportional entitlement to Swiss withholding tax refunds, provided that:

- the contractual relation between the investors and the fund management is of a fiduciary nature – which is the case for contractual investment funds; and
- the (foreign) fund is not itself in a position to reclaim any Swiss withholding tax.

It is up to the (Swiss resident) investor to demonstrate how many fund shares were issued as of the end of the fiscal year, at what point in time the investor has acquired or disposed of such fund shares, and at what point in time the income distributions by the fund fell due and were realized. The Court stressed that the same rules also apply to non-Swiss resident investors in a transparent foreign collective investment scheme claiming refunds of Swiss withholding tax with regard to underlying Swiss income based on an applicable Swiss tax treaty, and that there is no reason for any conceptually different tax treatment of Swiss resident fund investors with regard to their principal entitlement to reclaim Swiss withholding tax.

As a next step, the Supreme Court had to examine whether the Swiss pension fund could be considered to have "duly accounted" for the income in question within the meaning of article 25 of the WHT Act. The SFTA had claimed:

- that the Swiss pension fund had not accounted for the actual Swiss dividends (which directly accrued to the Irish Fund), but had only reflected an increase in value of the units held in the Irish Fund;
- that such fund units were not equivalent to the underlying Swiss shares; and
- the value increase of the fund units was not identical to the income derived from the underlying Swiss shares.

The Swiss pension fund, on the other hand, argued that it had complied with relevant Swiss tax accounting regulations by recording the Swiss income (as fund distributions) on a net basis and by separately recording the withholding tax refunds when received in its income statement.

After a lengthy discussion of Swiss accounting standards applicable to Swiss regulated pension funds (Swiss GAAP FER), the Supreme Court concluded that in the case at hand, the Swiss pension fund had complied with those standards and had supplied all necessary information to the SFTA so as to allow the SFTA to control and review and to determine whether there was any case of multiple or abusive reclaim of Swiss withholding tax. Among such information, a certification by the global custodian of the amount of Swiss withholding tax deducted on each unit held in the Irish Fund was of particular importance. In the case at hand, it was sufficiently clear that the Swiss pension fund had comprehensively accounted for all relevant Swiss income and for the re-investment thereof in additional shares. Furthermore, the Irish Fund had, in fact, made frequent distributions of the income received from the investments to the fund shareholders. The certifications of the income and the deducted Swiss withholding tax issued by the global custodian proved helpful in proving that everything had been properly and comprehensively been accounted for.

Consequently, the Supreme Court also rejected the argument of the SFTA of lack of "due accounting" for the Swiss income in question and confirmed that the Swiss pension fund had met all conditions for reclaiming Swiss withholding tax deducted from the underlying Swiss dividends derived through the transparent Irish Fund. This led to the dismissal of the appeal by the SFTA.

3. Conclusion

The decision is to be welcomed, as it clarifies the Supreme Court's position with regard to Swiss withholding tax reclaims on investments held via a fiscally transparent investment vehicle.

The author has been informed that the SFTA intend to use this Supreme Court ruling to claim transparent tax treatment also with regard to federal stamp taxes on transfers of securities for consideration. Accordingly, a Swiss corporate investor qualifying itself as a "securities dealer" for stamp duty purposes would be held liable for transfer stamp duty on the purchase and sale transactions for underlying equity and debt securities made by the fund or similar transparent investment vehicle. The author considers this approach to be flawed. Stamp duties are indirect taxes imposed on certain legal transactions generally requiring a strictly formal approach. For stamp duty purposes, Swiss and foreign investment funds are generally treated as exempt investors. As a consequence, transactions with or for such entities by a Swiss securities dealer are half exempt from stamp duty. Purchase and sale transactions by such fund entities on behalf of their investors would normally not be attributed back to the investors for stamp duty purposes, regardless of whether the fund is considered fiscally transparent or opaque for direct (income and withholding) tax purposes. This development will require close monitoring and may lead to further tax litigation.