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Briefing January 2018

Securities Lending and REPOs: Amended Rules for Refund of Swiss Withholding Tax

There are no specific rules in Swiss tax law on securities lending and borrowing ("SLB") or REPO transactions. Such transactions were thus far governed by administrative guidance published by the Swiss federal tax administration ("FTA") in its circular letter no. 13 on 1 September 2006 ("Circ. 13").

As of 1 January 2018, Circ. 13 underwent material changes regarding the possibility of Swiss withholding tax refund claims by non-Swiss borrowers under SLB arrangements over Swiss securities. As the circular letter not only applies to SLB transactions, but also to REPOs, the new rules equally affect mutatis mutandis refund claims by non-Swiss cash providers under REPO arrangements over Swiss securities.

According to the FTA, the reason for amending the rules was a perceived misuse of double tax treaties by non-Swiss borrowers on behalf of lenders, through which the refund percentage was enhanced (so-called dividend arbitrage). The amended rules were also inspired by a decision of the Swiss federal administrative court of 20 December 2016, in which a refund of Swiss withholding tax was denied to a non-Swiss borrower because of a lack of beneficial ownership in relation to the dividends received.

Summary of the rules applicable until the end of 2017

Under the old rules, which applied until the end of 2017, non-Swiss borrowers of Swiss securities were allowed to claim a refund of Swiss withholding tax if they held securities over the dividend or interest date (so-called "long borrowing"), i.e. securities were not sold to a third party prior to the dividend or interest payment date. The refund percentage corresponded to the rate stipulated in the double taxation treaty between Switzerland and the borrower's country of residence. Where the securities were sold to a third party prior to the dividend or interest date, only the third party buyer (to whom the original dividend or interest was paid) could claim a refund of the Swiss withholding tax, and neither the lender nor the borrower under the SLB arrangement had a right to file a refund claim.

Granting a right for a refund to the non-Swiss borrower in cases of long borrowing was initially considered by the FTA as a "pragmatic solution" for SLB arrangements over Swiss securities which, by inadvertence, extended over a dividend or interest due date. Analysis performed by the FTA over the last few years – via extensive questionnaires sent to non-Swiss claimants – apparently showed that this pragmatic approach led to targeted misuse by foreign owners of Swiss securities: According to the FTA, Swiss securities were lent to borrowers with a better withholding tax refund rate than the one available to the lender, leading to tax treaty shopping in the FTA's perception.

The amended rules applicable from 2018

Where the non-Swiss borrower sold the Swiss securities to a third party prior to the dividend or interest due date, the rules remain unchanged: Neither the lender nor the borrower will be allowed to claim any refund of Swiss withholding tax, and such right to reclaim sits exclusively with the third party acquirer, based on Swiss domestic law or applicable tax treaties.

In circumstances involving long borrowing, however, the situation is reversed under the amended rules. Instead of the non-Swiss borrower, it is **the lender who has a right to claim a refund** of the Swiss tax. This lender is understood to be the ultimate lender in a chain: Where the SLB transaction is made over one stage only, it is the direct lender to the non-Swiss borrower; in case of a chain of SLB transactions, it is the very first lender in the chain. The refund claim may be based on Swiss domestic law where the lender is a Swiss person, or on applicable double taxation treaties where the ultimate lender resides in a tax treaty jurisdiction. The amended circular letter requires that the refund claim by the lender is supported by proof that the income received by the borrower, which was passed on to the lender under the SLB arrangement, actually was an original interest or dividend which suffered a deduction of Swiss withholding tax of 35%. Such proof is required to demonstrate that the non-Swiss borrower actually held the security over the dividend or interest payment date (long borrowing), and that the security was not disposed of by the borrower prior to that date.

The FTA does not give any guidance as to the form such proof must take; it can be assumed, however, that it includes the original payment advice sent to the borrower for the dividend or interest received. Furthermore, the lender must disclose the SLB or REPO arrangement as well as the counterparty to that arrangement, as the payment advice received by the borrower does not show the lender's name, and would therefore be rejected by the FTA failing such disclosure. If there is a chain of SLB or REPO transactions, the entire chain must be disclosed to establish a link between the original payment advice showing the ultimate borrower's name and the ultimate lender filing for a refund. While a draft of the amended circular letter of the FTA contained an explicit requirement to disclose the entire chain of transactions, this did not find its way into the final version. However, it is difficult to conceive how the required proof could be established without disclosing the entire chain.

Comments

It is understandable that the FTA wants to tackle treaty-shopping situations by not acknowledging refund claims of claimants who are not beneficial owners of the dividends and interest in relation to which Swiss withholding tax was deducted. Attributing the right to a refund to the lender, rather than the borrower, therefore looks to be a means to achieve this objective.

However, it appears that the FTA has set the bar for successful refund claims by lenders too high. First of all, the lender needs to get its hands on the original payment advice received by the borrower, which can be difficult in practice, in particular where a chain of lenders is involved. Secondly, financial market participants who are active in borrowing and lending of securities often do not know the entire chain of transactions, at least where such transactions happen between unrelated parties; they would, therefore, not necessarily know the origin and destination of the securities, i.e. whether there will be other SLB or REPO transactions further up or down the chain. Due to banking secrecy and data protection laws, counterparties of a lender are generally not allowed to disclose the origin or destination of a security and the

identity of their counterparties. As a result, it is likely that where there is a chain of transactions, the ultimate lender would find it challenging to provide the proof required by the FTA. Consequently, a successful filing of a refund claim appears to be unduly difficult.

Therefore, the new measures seem to be too burdensome to allow for a smooth refund of Swiss tax. They make it hard if not impossible for the parties, at the time of entering into an SLB or REPO transaction, to gauge the success of a Swiss refund claim, as neither the party entitled to such a refund, nor the expected percentage of the refund, can be predicted with certainty ex ante, since these questions depend on the behaviour of the participants after entering into the transaction (e.g.: Will the security be held by the borrower on the dividend or interest due date, or be sold on to a third party? Will the ultimate lender succeed in obtaining the necessary documentation from the last borrower down the chain who suffered the withholding tax on the original payment?). This unpredictability makes the pricing of such transactions difficult for all parties involved; at best, such trades, if entered into over dividend or interest due dates, can expect to be priced as if no Swiss tax refund were available. It can therefore be expected that the market for SLB and REPO transactions over Swiss securities, which has already slowed down over the past few years following the tightening of the FTA's practice, will remain lethargic, in particular where such transactions would extend over dividend or interest due dates.

Other aspects

In all other material aspects, the amended circular letter of the FTA remained largely unchanged:

– Swiss resident borrowers still have the obligation to withhold a tax of 35% on any pass-on payments and manufactured dividends/interest to Swiss and non-Swiss lenders, calculated on the amount of the original dividend or interest (so-called "2nd withholding tax"). This 2nd withholding tax must be paid to the FTA, but can be netted with the refund claim for withholding tax on the original dividend/interest. (In the authors' view, this 2nd withholding tax never had, and still has no foundation in Swiss statutory law, even though it represents widely accepted banking practice.)

– Swiss lenders may claim a refund of this 2nd withholding tax on the basis of Swiss domestic law, while non-Swiss lenders can file such claim on the basis of applicable double taxation treaties.

– In case of pass-on payments, Swiss borrowers have to issue a withholding tax statement to the lender, stating that this is a pass-on payment, referencing the underlying original dividend or interest, and showing the amount of 2nd withholding tax deducted.

– There is no right or obligation of Swiss borrowers to withhold any foreign tax in relation to non-Swiss securities.

– Pass-on payments are not eligible for Swiss participation relief, but are fully taxable if received by a Swiss corporate lender.

– A transfer of securities under SLB or REPO arrangements is not subject to Swiss securities transfer tax.

Timing

The amended rules apply as of 1 January 2018. There is no grandfathering for SLB or REPO transactions entered into before 1 January 2018; the new rules therefore apply to all dividend or interest due dates as of 1 January 2018.

Open SLB and REPO contracts should be reviewed in the light of these amended rules. Where a lender becomes entitled to claim a refund under the amended rules, the necessary documentation should be requested and then obtained from the counterparties.

Contractual terms should be reviewed for any new contracts entered into, in particular in terms of pricing of the transaction as well as documentation and disclosure obligations.

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