Switzerland

Securities Lending and Repo Transactions: Amended Tax Regulations

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1. Introduction

Over the last decade, Swiss tax authorities have paid increased attention to federal withholding tax (WHT) refund claims, in particular where the underlying securities were subject to a financial transaction such as securities lending and borrowing or repo, or where derivative financial instruments were involved. The reason for the closer scrutiny by tax authorities was the perceived risk that these transactions allowed obtaining tax refund in favour of persons not entitled to it (such transactions are commonly known as "dividend stripping", "dividend washing" or "yield enhancement" transactions), or in some instances allowed for dual or multiple refunds where only one underlying withholding tax was paid. The efforts of the Swiss tax authorities were supported by a series of Swiss court decisions[1] which had denied WHT refunds on grounds of perceived lack of beneficial ownership of the claimant, and which were in line with a wider trend in Switzerland and elsewhere that regulators would review the conditions under which a tax refund is granted. In this context, Switzerland's Federal Tax Administration (FTA) recently amended its guidance regarding WHT refund in the context of securities lending and borrowing (SLB) and repo transactions.

1.1. Securities lending and repo transactions in Swiss tax law

Switzerland had administrative regulations on the taxation of SLB and repo transactions in place ever since the 1990s. One of the regulations' principal purposes was the prevention of unjustified refunds of Swiss WHT. The regulations were issued by the FTA, partly in conjunction with the Swiss Banking Association. Although they do not have the power of formal laws and are therefore not binding on courts, they have provided guidance to taxpayers and were widely adopted by them.

On 1 September 2006, the FTA had published circular letter 13 (Circular 13) on SLB and repo transactions; among other things, Circular 13 stipulated an obligation on Swiss resident borrowers (or repo buyers) of Swiss securities with a taxable dividend or interest coupon to deduct and submit to the FTA a secondary withholding from pass-on ("manufactured") payments made to their lenders (or repo sellers). The regulation also defined which person was entitled to file for a reclaim of WHT, thereby distinguishing different scenarios. In particular, under certain conditions, Circular 13 gave non-resident borrowers of Swiss securities a right to claim (partial) refund of WHT, provided they were resident in a jurisdiction that had a tax treaty with Switzerland.

1.2. Background of the revision of Circular 13

Over the past decade, the FTA scrutinized thousands of WHT refund claims made by Swiss and non-Swiss claimants. Since the FTA has no authority to directly audit foreign claimants, it sent them extensive questionnaires, which the claimants had to respond to in order not to forfeit their refund claims. Where the FTA determined that a claimant had entered into a securities lending, repo or another derivative financing transaction in relation to the securities for which a reclaim was filed, it usually refused to grant any refund on the grounds that the claimant had no beneficial ownership over the income received, or that the claim was abusive. Claimants then were left to either abandon the claim, or to challenge the FTA's rejecting decision in court.

It was not least a decision issued in late 2016 by the Federal Administrative Court (FAC) that sparked a review of the tax regulations governing SLB and repo transactions.[2] The court case involved a Luxembourg resident claimant that had continuously borrowed Swiss equities under an SLB arrangement with a UK resident affiliate and claimed a refund of Swiss WHT on the dividends received. The FTA had turned down the claim, as they concluded that the borrower had no beneficial ownership over the Swiss dividends received. The FTA thereby decided not to apply Circular 13, according to which the "long" borrower would in principle have been entitled to a WHT refund. The FAC, which as a judicial authority is not bound by administrative guidance such as Circular 13, upheld the FTA's position and confirmed the denial of the tax refund.

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1. Cf. among others the decisions of the Federal Supreme Court of 5 May 2015, cases 2C_364/2012, 2C_377/2012 and 2C_895/2012; *see* P. Reinarz & F. Carelli, *Court Rulings on Dividend Stripping and Denial of Swiss Tax Treaty Benefits*, 18 Derivs. & Fin. Instrums. 4 (2016), Journals IBFD.
2. Decision of the Federal Administrative Court of 20 Dec. 2016, case A-1426/2011; *see* P. Reinarz, *Court Denies Tax Treaty Benefits to Long Borrower of Swiss Shares*, 19 Derivs. & Fin. Instrums. 3 (2017), Journals IBFD.

The court case, as well as the evidence gathered through the review of numerous reclaim files, led the FTA to assume that the rights of refund conferred by Circular 13 were misused by certain market participants. While the granting of a right of refund to non-resident borrowers was initially considered by the FTA as a "pragmatic solution" in the case of "incidental over-borrowing" of Swiss securities over a dividend or interest due date, the FTA came to the conclusion that this pragmatic solution was systematically exploited by these market participants. Under a common scheme, Swiss securities were systematically lent over the dividend or interest coupon payment dates to non-Swiss, tax treaty country resident borrowers to enable such borrowers to file for a WHT refund on the basis of tax treaties applicable to them, thereby enhancing the net coupon return after WHT refund of the lenders or ultimate beneficial owners of the securities that benefited of the pass-on ("manufactured") payments.

Against this background the SFTA recently published a revised version of Circular 13 (Revised Circular 13), according to which non-resident "long" borrowers of Swiss securities with a dividend or interest coupon no longer have any entitlement to claim a refund of Swiss WHT; instead, such refunds can only be claimed by the lender, subject to rather restrictive conditions (*see* section 3.2.). The new guidance became effective as of 1 January 2018, without any grandfathering period. Any dividend or interest coupons falling due on or after 1 January 2018 affected by a SLB or repo arrangement fall under the Revised Circular 13.

1.3. Scope of application of the Revised Circular 13

Circular 13 exclusively addresses SLB and repo transactions; it is not applicable, however, to any other types of transactions, such as ordinary sell/buy-back arrangements or transactions involving derivative financial instruments (swaps, futures, etc.). The revision of Circular 13 has not changed this.

In its introduction, Circular 13 states that under an SLB arrangement, the borrower acquires legal ownership of the securities borrowed; it is, however, not a purchase agreement. At the term of the transaction, the borrower is required to transfer back equivalent securities to the lender, i.e. of the same kind and amount (fungibility). From an economic perspective, the borrower borrows securities, pays a lending fee, makes an agreed compensation payment if the agreement extends over a dividend or interest coupon payment date, and may provide cash or security collateral. The lender pays interest on the cash collateral.

A repo is a spot sale and a forward purchase by the original owner (cash taker). The interim holder (cash provider) acquires legal ownership during the term of the repo. The interim holder's obligation is to sell back securities of same kind and amount (fungibility) on the forward leg. From an economic perspective, the original owner borrows money, pays interest and provides securities collateral, where the interim holder provides the cash loan and makes an agreed compensation payment to the original owner if the arrangement extends over the dividend or interest coupon payment date. The price differential between the sales price and the repurchase price is the cost to the original owner for borrowing cash (repo rate).

2. Original Payment and Compensation Payments

Circular 13 focuses on those SLB and repo transactions that run over a dividend or interest coupon payment date. The securities lender or repo seller would thus forego the payment of the original dividend or interest coupon arising on the securities; it would, therefore, generally be compensated by the borrower or repo buyer with a compensation ("manufactured") payment that replaces the original coupon payment.

Swiss resident issuers of shares, bonds or notes, or their paying agents (usually Swiss banks) are legally required to deduct and withhold 35% federal withholding tax from the gross amount of their original dividend or interest coupon payments and to remit such tax to the FTA within 30 days of the payment or due date of the relevant coupon payment.[3] The Swiss issuer (or its paying agent) is also required to issue a withholding tax certificate to the beneficiary of the taxable payment, specifying the gross amount of the taxable payment and the 35% tax deducted.[4] This certificate will in principle enable the beneficiary to subsequently claim appropriate relief from WHT (through full or partial refund, or through credit against the income tax liability of a resident individual, as the case may be) pursuant to the terms of the WHT Act[5] or of any applicable income tax treaty.

Circular 13 draws a fundamental distinction between original coupon payments and compensation payments. Original payments are described as "genuine" payments of dividends or interest by (or on behalf of) the issuer of a corporate share, bond or note, after deduction of applicable Swiss or foreign withholding tax. Circular 13 summarizes all different types of compensation payments under an SLB or repo transaction under the notion of "compensation" payments and makes no further distinction. This includes pass-on payments of an original payment by a "long" borrower, pass-on payments of an underlying compensation payment, as well as actual "manufactured" payments financed from the own pocket of a borrower that has already disposed of the securities before the original coupon payment falls due.

In the event of any compensation payment made by a Swiss resident borrower (or repo buyer) of Swiss securities, Circular 13 requires such Swiss borrower to issue a certificate to the lender for such compensation. The certificate must identify the payment as a compensation payment, include the reference to the underlying original payment and state the amount of Swiss withholding tax deducted (*see* section 3.1.).

3. Art. 4(1) and art. 13(1) WHT Act.
4. Art. 14(2) WHT Act.
5. Art. 21(1) WHT Act.

3. Securities Lending and Borrowing with Swiss Securities

3.1. Swiss borrower

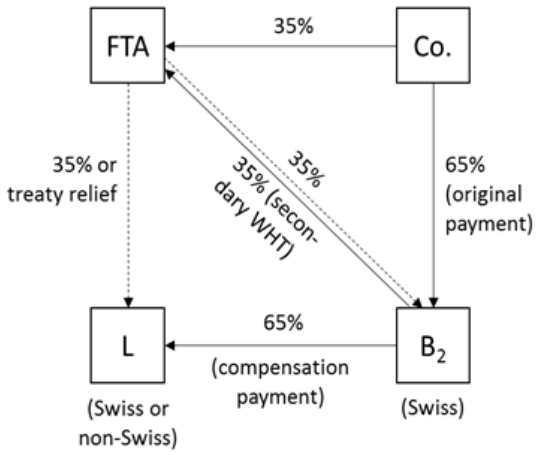
Circular 13 stipulates an obligation of Swiss resident borrowers to apply (and to submit to the FTA) a secondary Swiss WHT to any compensation payments made to resident or non-resident lenders (the recent revision of Circular 13 has not brought about any change in that regard). The secondary WHT always corresponds to 35% of the underlying original payment, regardless of the actual amount of the compensation paid. It must be accounted for by the Swiss resident borrower (or repo buyer), regardless whether the borrower does or does not hold the borrowed securities on the coupon payment date.

Where the Swiss resident borrower is a “long” borrower on the coupon payment date, it will receive an original coupon payment from the Swiss issuer (or its paying agent). The Swiss “long” borrower will usually be entitled to reclaim the WHT deducted from the original payment, based on the WHT certificate received from the issuer or its paying agent. The WHT reclaim for the original payment may be offset against the secondary WHT payment obligation on the compensation payment made by the Swiss borrower to the lender. According to the language used in Circular 13, the Swiss “long” borrower’s acceptance of the obligation to apply and pay the secondary WHT with regard to the compensation payment made is a “condition precedent” for such borrower’s entitlement to reclaim the WHT suffered on the original coupon payment. This means effectively that the payment of the secondary WHT (for which no basis can be found in the WHT Act, nor in legal regulations thereunder) relieves the Swiss “long” borrower from its general duty to prove that it is the beneficial owner of the original coupon payment.[6]

Circular 13 further provides that the lender (or repo seller) may principally reclaim the secondary WHT deducted from the compensation payment by the Swiss borrower in accordance with the provisions of the WHT Act (in the case of a domestic lender), or of any applicable double taxation treaties (in the case of a lender residing in a tax treaty jurisdiction), whereby the refundable amount is calculated by reference to the nature of the underlying original payment (dividend or interest). To make such a reclaim of secondary WHT, the lender will principally rely on the certificate received from the Swiss borrower (*see* section 2.).

6. Based on a recent decision of the Federal Supreme Court (rendered on 21 Nov. 2017, case 2C_123/2016) that dealt with a somewhat similar “secondary WHT” on a different type of “manufactured dividend”, namely dividend compensations charged by the banking system to short sellers of Swiss equities with a dividend coupon and credited to the buyer of the securities, it may be concluded that these “secondary withholding taxes”, which are imposed merely based on administrative regulations do not actually meet the legal prerequisites of a tax imposed under the Swiss WHT Act or any other legislation, but rather have the nature of a preemptive compensation of the federal fiscus for the risk that two or multiple WHT certificates are issued in a situation where actually only one withholding tax was deducted and paid on the original dividend paid by the Swiss issuer. In the case of securities borrowing (or repo) by a Swiss resident “long” borrower (or repo buyer) over a coupon payment date, the risk that the domestic borrower – in view of the typical compensation payment made to the lender – might not be the true beneficial owner of the coupon payment is simply “compensated” with the requirement imposed on such borrower to apply this “secondary WHT” to the compensation paid. Whilst obviously outside the scope of relevant withholding tax legislation, this represents a typically Swiss “pragmatic solution”.

Figure 1: Swiss "long" borrower



Where the Swiss borrower has disposed of the borrowed securities before the coupon payment date, it is not entitled to reclaim any WHT on the original coupon payment; hence it cannot settle the secondary WHT payment obligation by offsetting the WHT reclaim for the original payment. In that case, the secondary WHT must actually be submitted in cash to the FTA.

3.2. Non-Swiss borrower

The recent amendments to Circular 13 essentially affect the withholding tax reclaim position of non-Swiss resident borrowers (and repo buyers) of Swiss equity and debt securities. Under the previous version of Circular 13, which applied to original coupon payments and relating compensation payments becoming due up until 31 December 2017, non-resident borrowers of Swiss securities were principally entitled to claim a refund of Swiss WHT, if they actually held the borrowed securities on the dividend or interest coupon payment date (long borrowing). The refund percentage was determined by the double taxation treaty between Switzerland and the borrower's country of tax residence.

The revision of Circular 13 has removed any entitlement of non-Swiss resident (long) borrowers (or repo buyers) of Swiss securities to reclaim any Swiss WHT. Instead, the revised Circular 13 principally allocates the entitlement to reclaim Swiss withholding tax deducted from the original coupon payment to the original lender, where the foreign borrower, or the last borrower in a chain of SLB (or repo) transactions holds the borrowed securities on the original coupon payment date. Where the original borrower, or the last borrower in a chain of SLB transactions, has disposed of the borrowed securities prior to the coupon payment date, only the person that has acquired and that effectively holds the securities and receives the original coupon payment is entitled to such reclaim. In that case, neither the first nor any subsequent borrower in a row, nor the lender holds any entitlement to reclaim Swiss WHT (Circular 13 has remained unchanged in that regard).

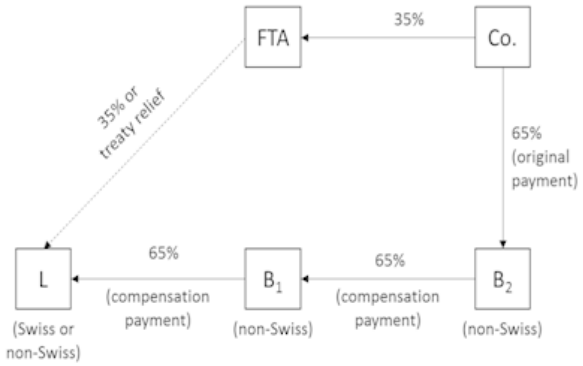
The original lender's potential entitlement to reclaim any Swiss WHT deducted from the original coupon payment is subject to a number of strict conditions:

(1) where the foreign borrower is a "long" borrower, it is now the *lender* that may reclaim Swiss WHT deducted from the original coupon payment, provided that the lender can prove that its borrower has received an original coupon payment that has suffered a deduction of Swiss WHT (which implies that the foreign borrower was actually a "long" borrower and did not dispose of the securities prior to the coupon payment date), and that the borrower has passed on such original payment to the lender; and

(2) where the foreign borrower is only the first borrower in a chain of further SLB transactions, the original lender may be entitled to reclaim WHT deducted from the original coupon payment, if it can prove that it has been passed on the original coupon payment (net of Swiss WHT) through the chain of SLB transactions – implying that the last borrower in the chain was a "long" borrower, received the original coupon payment (net of Swiss WHT) and passed that payment on to its lender, which passed it on to its lender, and so forth up to the original lender.

The FTA does not give any guidance as to the form such proof by the ultimate lender must take. It may be assumed, however, that the lender will need to produce a copy of the original tax certificate received by its borrower, or by the last borrower in a chain of further SLB transactions, from the Swiss issuer of the securities (or its paying agent). Although no explicit guidance can be found in the revised Circular 13, this means presumably that in practice the existence of one or more SLB transactions, as well as the parties to those transactions have to be disclosed by the ultimate lender to the FTA. It would otherwise be hardly perceivable how else the ultimate lender could provide the necessary proof.

Figure 2: Chain of transactions with ultimate foreign "long" borrower



3.3. Comments on the revised rules

It is understandable that the FTA wants to tackle treaty-shopping by not acknowledging refund claims of claimants that are not beneficial owners of the dividends and from which Swiss WHT was deducted. Attributing the right of refund to the lender, rather than to the borrower, could be a suitable 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, lenders that file for refund of Swiss WHT need to get their hands on the original tax certificate received by the borrower. This can be difficult in practice, in particular where a chain of lenders is involved. Contractual safeguards therefore need to be included in SLB agreements in order for the lenders to receive this documentation from the (ultimate) borrower.[7]

Secondly, financial market participants that are active in borrowing and lending of securities often do not know the entire chain of transactions, in particular where such transactions happen between unrelated parties. A lender would therefore not necessarily know the destination of the securities, i.e. whether its borrower will on-lend the securities further in another SLB or repo transaction, or sell or deliver them to a third party. In addition, due to banking secrecy and data protection laws, borrowers may be effectively barred from disclosing the identity of their counterparties. As a result, especially in case of a chain of transactions, the first lender may find it challenging, if not impossible to provide the proof required by the FTA. Overall, successful filing of refund claims by lenders appears to be difficult.

As a result, the new rules make it hard for the parties, at the time of entering into an SLB or repo transaction with a non-Swiss borrower, to gauge the success of a Swiss WHT refund claim, as it is at that point in time uncertain whether the lender will ever be in a position to file a claim. This question depends on how the original borrower, and any subsequent borrowers in a chain, will deal with the borrowed securities, i.e. whether they hold on to the securities over the coupon payment date, or dispose thereof before that date. Combined with the difficulty in obtaining the required documentation for a successful WHT reclaim, the success of such a claim becomes rather unpredictable, which likely impacts on the pricing of such SLB or repo transactions. Presumably, such transactions will tend to be priced as if no Swiss tax refund were available.

4. SLB and Repo Transactions with Non-Swiss Securities

A Swiss resident borrower of foreign securities that holds the securities over the dividend or interest due date (long borrowing) and consequently receives an original payment of dividend or interest subject to foreign WHT may be entitled to a refund of the foreign WHT according to the domestic law of the issuer or applicable double taxation treaties. Whether or not a refund can be obtained is not a matter of Swiss law, but subject to the tax rules applicable in the issuer's jurisdiction.

The Swiss resident borrower will generally have to make a compensation payment to the lender, the amount of which may be freely agreed between the parties. This compensation payment is not subject to Swiss WHT; whether any foreign WHT applies is a matter of foreign law. The revised Circular 13 requires the resident borrower to issue a confirmation statement to the lender, which clearly discloses the fact that the lender is receiving a compensation payment (and not an original payment), and which refers to the underlying original payment. However, the confirmation statement must not reflect any non-Swiss WHT, in order to prevent it from being (mis-)used as a tax certificate for purposes of reclaiming foreign WHT.

5. WHT on Cash Collaterals

Interest on cash collaterals as well as repo rates paid by Swiss banks in the meaning of the WHT Act[8] are, in principle, classified as interest from Swiss bank deposits and are thus subject to 35% Swiss WHT, unless the beneficiary of the payment qualifies as a bank according to Swiss or equivalent foreign banking legislation and can therefore benefit from the so-called "interbank exception".[9]

6. Corporate Income Tax

Original payments of interest or dividends are classified as taxable income at the level of a Swiss resident borrower. The resident borrower is entitled to participation relief in respect of the original dividend, if the relevant conditions are met.[10]

Compensation payments are classified as taxable income at the level of the Swiss resident lender and as business expenses at the level of the Swiss resident borrower. The resident lender is not entitled to participation relief for the dividend compensation received.

Lending fees are classified as taxable income at the level of the resident lender and as business expenses at the level of the resident borrower.

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7. In addition to the original tax statement, where equities are held in a deposit at a non-Swiss bank, the claimant needs to be in possession of a special "tax voucher" issued by the depository bank, which needs to be joined to any WHT refund claim. In this voucher, the depository bank confirms that the amount of income stated in the tax statements that can be used for reclaiming Swiss WHT does not exceed the amount of income confirmed to it by other banks/custodians (usually a Swiss custodian holding the Swiss shares in custody). This tax voucher requirement has been enacted by administrative guidance of the FTA in circular letter 21 of 1 Apr. 2008, and aims at preventing double or multiple refund claims over the same income from which Swiss WHT was deducted only once.
8. In addition to Swiss banks according to Swiss banking legislation, art. 9(2) WHT Act and FTA circular letter 34 consider to be a bank any person who publicly accepts cash deposits from more than 100 non-bank creditors against interest, if the total amount of deposits is at least CHF 5 million.
9. This exception was introduced by FTA circular letter S-02.123 of 22 Sept. 1986. It basically means that interest bearing deposits made with a Swiss bank by another Swiss or foreign bank are not considered "customer deposits", and are hence not subject to federal withholding tax on bank deposit interest.
10. Arts. 69 and 70 of the Federal Direct Tax Act and art. 28(1) and (1bis) Federal Tax Harmonisation Act, i.e. the dividend is derived by a corporate entity from an equity investment that either corresponds to at least 10% of the paying corporation's share capital, or has a fair market value of at least CHF 1 million.

SLB and repo transactions extending over the dividend or interest payment due date are particularly scrutinized by tax authorities for tax evasion, especially where a borrower claims participation relief in respect of an original payment, and treats the compensation payment as a fully deductible expense.

7. Individual Income Tax

Resident individuals must include original payments of dividend and interest, compensation payments and lending fees in their taxable income.

Compensation payments and payments of lending fees made by individuals are generally deductible from income, if these payments concern the individual's business property (*Geschäftsvermögen/fortune commerciale*).

In the case of transactions entered into for the private property of individuals (*Privatvermögen/fortune privée*), lending fees and compensation payments are only deductible where the resident borrower held the securities over the dividend or interest payment due date (long borrowing) and consequently received the original payment. In the resale scenario, lending fees and compensation payments are not deductible from income.

8. Transfer Stamp Duty

SLB and repo transactions are not subject to federal stamp duty on the transfer (turnover) of securities.

9. Conclusion

The revised Circular 13 maintains the obligation of Swiss resident borrowers of Swiss securities to deduct and pay a "secondary WHT" on any compensation payments made to resident or non-resident lenders, which was introduced by the original version of Circular 13. Lenders may be entitled to claim refund of this secondary WHT on the basis of applicable domestic or treaty law.

However, non-Swiss resident borrowers of Swiss securities are no longer entitled to any refunds of Swiss WHT. A refund may be granted to (Swiss or foreign) lenders, provided that the lenders can properly document that they were passed on an original coupon payment, net of 35% WHT deducted, by the (ultimate) "long" borrower of the securities. By granting the right of refund to the lender, and no longer to the borrower as was the case under the original version of Circular 13, the FTA expects to successfully prevent "abusive" WHT refund claims by claimants that are not beneficial owners of the coupon payments. However, in practice, many lenders risk to forfeit their (legitimate) refund claims as they cannot provide the necessary documentation and disclosure required by the FTA. This is likely to have an impact on the pricing of SLB and repo transactions with Swiss securities, where such transactions extend over the dividend or interest due date.