Switzerland

The Swiss Tax Case on Short Sales cum Dividend

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Issue: Derivatives & Financial Instruments, 2019 (Volume 21), No. 2
Published online: 28 March 2019

This article discusses the recent Swiss court case on cum-ex short sales and the tax treatment of secondary withholding tax payments.

1. Introduction and Background

The Swiss Federal Supreme Court recently (on 21 November 2017) rendered a judgment in a tax case involving short sales of Swiss exchange-traded shares shortly before dividend payment dates (case no. 2C_123/2016). A UK-based broker-dealer had brokered futures based on several Swiss publicly traded stocks and entered into short sales cum dividend of those shares, whereby it delivered shares without dividend coupons to buyers (so-called "cum-ex" trades). The short seller had to procure the shares to be delivered to the buyers from third parties, which had already been credited with a net dividend (after the deduction of the applicable 35% Swiss withholding tax).

The short seller was first charged with the net dividends (i.e. 65% of the gross dividend amounts pertaining to the sold shares), and later it was charged by its Swiss sub-custodian bank for another 35% (an aggregate amount of close to CHF 55 million), representing "secondary" Swiss withholding taxes on the underlying dividends. The short seller first sought a reimbursement of this secondary withholding tax from its sub-custodian in commercial litigation, but without success. The Zurich Commercial Court concluded that the Swiss sub-custodian bank made the secondary withholding tax payment (and charge-back to the short seller's account) in compliance with Swiss regulations applicable to the bank and accordingly rejected the short seller's civil law claim. After that, the short seller sued the Swiss Federal Tax Administration (FTA) for a reimbursement of the secondary withholding taxes. In essence, the short seller argued that the FTA had collected this secondary withholding tax illegally, absent any statutory basis for such a secondary withholding tax. Although the Supreme Court confirmed in its ruling that there is currently no basis in Swiss withholding tax law for such a secondary withholding tax, it nonetheless rejected the reimbursement claim.

2. Facts of the Case and Relevant Stock Market Mechanism

The UK broker-dealer in question was engaged in substantial financial derivative trading activities, inter alia in derivatives with Swiss-listed shares underlying. In connection with such trading activities, in 2007 the broker-dealer entered into short sales of Swiss shares cum dividend coupon just before the dividend payment dates on the SIX Swiss Exchange and settled the trades shortly after the dividend dates. As the shares needed for settlement and delivery had to be procured after the dividend payment, they actually came without the dividend coupons ("ex dividend"). However, as a matter of Swiss market practice, the Swiss banking and settlement system nonetheless would credit the buyers with a net dividend (i.e. the gross dividend, minus 35% applicable federal withholding tax) and provide the buyers with dividend statements reflecting the gross dividend and certifying the deduction of 35% withholding tax.

In a first step, the Swiss banking and settlement system would debit any seller that has sold Swiss shares cum dividend with a net dividend (i.e. 65% of the gross dividend), regardless of whether the seller actually held the sold shares in its account on the "ex date"; i.e. the same amount would be debited to either long or short sellers. However, pursuant to an internal guideline issued by the Swiss Bankers Association to its member banks in 1990[1]through a circular letter, which had been developed in cooperation with the FTA, Swiss banks were required to determine any "short positions" in their own accounts, as well as in the custody accounts held for their customers. They were also required to account for a secondary withholding tax with the FTA, of which the amount would correspond to 35% of the gross amount of the actual dividends. Swiss banks were given a choice between two options, namely, (i) using a particular declaration form, "102M" for "manufactured dividends", specially drafted by the FTA; or (ii) making a deduction on their own withholding tax reclaims for their proprietary positions in Swiss shares and receipts of dividends.

In the case at hand, after the short sales cum dividend had been settled, the claimant first received account charges for the net dividends pertaining to the shares sold. However, several weeks later, the claimant, via its non-Swiss main custodian, received cancellations of the original net dividend charges from the Swiss sub-custodian bank, which were replaced by new charges equivalent to 100% of the dividends pertaining to the shares sold, reflecting the charge-back of both the net dividends and the 35% secondary withholding taxes. Upon a challenge by the claimant, the sub-custodian insisted that it was bound by "applicable Swiss regulations" to apply this secondary Swiss

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1. Swiss Bankers Association, Circular no. 6584 of 22 May 1990, hereafter called "SBA Circular 6584".

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withholding tax to the short positions in the claimant's subaccount, and eventually prevailed holding that position in a civil lawsuit before the Zurich Commercial Court. The claimant then sought a reimbursement of the secondary withholding tax from the FTA, but to no avail.

At first, the FTA took the position that the claimant had no legal standing in the process of collecting the secondary withholding taxes, which was a matter merely between the Swiss (sub)custodian bank and the FTA. Further, the FTA took the view that the secondary withholding taxes were indeed genuine withholding taxes imposed in accordance with the federal Withholding Tax Act (WHT Act), which, in the FTA's opinion, applied to both actual and merely "manufactured" dividends (the FTA used the notion of "artificial" dividends "created" by the claimant). Later in the process, after the Federal Administrative Court had confirmed that the claimant was affected by the secondary withholding taxes, and thus held a legal standing as a party in the administrative proceeding, the FTA slightly revised its legal position and maintained that the secondary withholding taxes had the character of a substitute of the actual dividend withholding tax, which was necessary to protect the proper functioning of the Swiss withholding tax system. The FTA argued that in order to ensure that no more items of withholding tax could be reclaimed and refunded than the withholding taxes effectively paid to the federal government, it was necessary to compensate the federal government for the risk of having to grant more than one refund of dividend withholding tax for the same dividend. Hence, the equivalent of another item of withholding tax had to be imposed on the manufactured dividend arising from the dividend compensation being charged to the seller and credited to the buyer of Swiss shares being sold over a dividend date, if the seller's account was short in the shares on the dividend payment date. The secondary withholding taxes would be calculated by reference to the amount of the underlying original dividends. Consequently, the FTA maintained that the Swiss sub-custodian had correctly applied the secondary withholding taxes to the claimant's short position, hence the claimant could not be issued any further certification for the deduction of withholding tax (as such certification could have given rise to yet another withholding tax reclaim).

3. Judgment of the Federal Administrative Court

3.1. Secondary withholding tax not covered by statutory law

The Federal Administrative Court rejected the first appeal of the claimant against the FTA's decision. The Court made clear that the secondary tax in question could not actually be regarded as a tax, as there is no explicit basis to be found for such a secondary tax in the relevant federal legislation. The secondary withholding tax cannot be based on mere customary law either. The Administrative Court determined that the SBA Circular 6584 constituted merely internal information about the FTA's practice, which could not substitute the legally required statutory basis for any additional tax. Statutory withholding tax law does not cover compensation payments for Swiss dividends, such as the manufactured payments in question. In order for a dividend to be taxable under the WHT Act, there must be a payment by or on behalf of the Swiss issuer, through which this issuer suffers a reduction in its net assets; i.e. the payment must ultimately be taken from the issuer's reserves from retained profits, and it must be based on the beneficiary's equity participation in the payer. However, the payment of a mere dividend compensation or a manufactured item does not involve the Swiss issuer of the shares at all. Such payments are not made by or on behalf of the issuer of the participation rights in question. Therefore, the Federal Administrative Court concluded that the secondary withholding tax in question, which had effectively been collected by the FTA from the Swiss sub-custodian, could not be regarded as a withholding tax in the legal sense, as the federal WHT Act did not provide any basis for the collection of such a tax.

3.2. No reimbursement of secondary withholding tax under article 12 of the WHT Ordinance

3.2.1. Federal Administrative Court findings

On that basis, the Federal Administrative Court had to consider further whether the claimant, to whose account the secondary withholding taxes had been charged, was entitled to recover these amounts from the federal government. Article 12(1) of the federal Withholding Tax Ordinance (WHT Ordinance) provides that any withholding taxes and late payment interest thereon, which were paid in the absence of a formal decision of the FTA, will be reimbursed as soon as it has been determined that the payment of such taxes and interest was not effectively due. Hence, the reimbursement under article 12 of the WHT Ordinance is contingent on the payment of a tax that was effectively not due. The Administrative Court clarified that this would be the case, inter alia, where the payment was made despite the absence of a taxable event, i.e. where the benefit, in respect of which the tax payment was made was effectively not taxable at all.

The Administrative Court went on to discuss the implications of article 14(1) of the WHT Act, which requires the debtor of a taxable payment to charge the burden of the withholding tax to the beneficiary of the taxable benefit. The Court held that in all likelihood, even where a benefit is not actually taxable, the debtor (payer) would normally charge the burden of the (undue) tax to the beneficiary and give the beneficiary the necessary information and documentation to request an ordinary refund from the FTA, as required under article 14(2) of the WHT Act. Accordingly, the Court held that where the beneficiary is enabled to effectively reclaim the (albeit undue) withholding tax from the FTA, no additional reimbursement of the undue tax to the debtor of the (indeed not taxable) benefit may occur. The Court stressed that, only where the undue tax was effectively charged to the beneficiary, but had not yet been refunded to the beneficiary by the time it emerged that the payment of the tax was not effectively due (or where it was apparent that the beneficiary would not be in a position to reclaim the undue tax in any case), a reimbursement of the undue tax to its actual payer could be justified. This is subject to the additional condition that the *beneficiary*, who has effectively borne the undue tax, is receiving the benefit of the reimbursement. Thus, article 12(2)

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of the WHT Ordinance stipulates that the reimbursement of the undue tax will occur only if the beneficiary affected by the charge-back of the undue tax has not obtained any tax refund through the ordinary refund procedure and will obtain the benefit of the reimbursement.

The Administrative Court pointed out that the tax issue at hand was not caused by the fact of the short sales of Swiss shares cum dividend as such, but rather by the specifics of the Swiss settlement and bank certification system in such situations, as the system firstly does not distinguish between “long” and “short” sellers. In either case, the system would treat the buyer as the beneficiary of the original dividend and accordingly issue a dividend certification to the buyer, which reflects a 35% withholding tax deduction. That is notwithstanding the fact that a short seller would indeed be unable to deliver shares cum dividend to the buyer, i.e. a short seller would effectively be forced to supply shares ex dividend to the buyer, contrary to its contractual obligation. In lieu of a true dividend coupon, the short seller can only deliver a dividend compensation (manufactured dividend) to the buyer. Nonetheless, the “optimized” banking and settlement system treats the buyer as if it had received an original dividend and accordingly issues a “normal” dividend statement to the buyer, certifying a deduction of withholding tax that in fact was never paid. The buyer is normally not in a position to see that this certification is incorrect and therefore would generally be protected in its reliance on the withholding tax certification.

After reiterating that SBA Circular 6584 does not represent a statutory basis for any secondary withholding tax levy, the Administrative Court referred to the civil law judgment of the Zurich Commercial Court, which had stated that the regime of SBA Circular 6584 reflected a piece of “self-regulation” by the Swiss banking industry and long-standing market practice. The Commercial Court had ruled that the Swiss sub-custodian acted in accordance with that self-regulation and dismissed any contractual, tort or unjustified enrichment-based claims of the claimant. According to the Commercial Court, the sub-custodian was contractually entitled to charge the claimant’s account for the secondary withholding tax, which the sub-custodian had reported and paid to the FTA.

The Administrative Court then turned to the question of whether the claimant was entitled to a reimbursement of the secondary withholding tax – which, as a matter of statutory withholding tax law, was not due to the state – by the FTA, and of whether the claimant had charged the burden of this undue tax to the beneficiary. First, the Court pointed to the fact that the sub-custodian had collected and submitted this secondary tax to the FTA in its own name. The Court referred again to article 12 of the WHT Ordinance, as well as the claimant’s confirmation that, although it had sold shares cum dividend coupon, it was only able to deliver shares ex coupon to the buyers, as the claimant was short in the shares on the dividend dates. Hence it made merely a compensation payment for the dividends to the buyers, which represented just 65% of the actual dividends. Thereby, the claimant derived benefit from the fact that, due to the mechanics of the banking and settlement system, the buyers received a full dividend statement with certification of a withholding tax deduction and, therefore, were not aware that they had only received a dividend compensation of 65% and had no reason to hold the claimant liable for the remaining 35% portion of the dividends. The Court concluded that the claimant had exploited the mechanics of the settlement system to only deliver the equivalent of 65% of the full dividends to its buyers, and that the claimant thereby charged the burden of the – albeit undue – secondary withholding taxes to the buyers.

This gave rise to the consideration of the Administrative Court that any reimbursement of the undue withholding tax to the claimant would require, pursuant to article 12(2) of the WHT Ordinance, that the buyers of the shares did not obtain any refund of this tax, as otherwise the state would have run the risk of having to refund withholding taxes twice. Moreover, the claimant would have had to pass on the reimbursed amounts to the buyers, as they had wrongfully only received a 65% dividend compensation, rather than full dividends – i.e. the buyers would have had to be put in the same position, as would have been the case if the share sale contracts had been correctly performed by the claimant. The Court determined that the claimant had not even asserted such facts and concluded that the conditions of article 12(2) of the WHT Ordinance for a reimbursement to the claimant were not fulfilled.

3.2.2. Reimbursement based on unjust enrichment of the state?

Finally, the Administrative Court addressed the question of whether the claimant, which had been charged by the sub-custodian not for a legally imposed tax but rather for a mere tax compensation, might be entitled to a reimbursement by the FTA on grounds of *unjust enrichment* . The burden of proof for such an unjust enrichment claim would be borne by the claimant.

The Court first investigated whether the FTA or the state was effectively enriched. In that context, the Court once again pointed out that the claimant, through its short sales over dividend dates, had created a situation whereby the buyers would receive full dividend statements including withholding tax deduction certificates, which would principally enable them to reclaim withholding taxes, even though they would not have been entitled to such refunds. Effectively, the short selling claimant burdened the state with the performance of part of its contractual delivery obligation towards the buyers (to the extent of 35% of the dividends) and thereby created a significant potential for financial damage to the state. The Court considered that such damaging potential was at least compensated by the secondary withholding tax payments in question. The state would have been enriched only to the extent that the claimant had managed to demonstrate and prove that buyers did not actually obtain any refunds of withholding tax. Overall, the Court concluded that the state’s enrichment was not proven. And even if there had been an enrichment, the Court expressed doubts whether this would have been “unjustified”, given that the Zurich Commercial Court had found that the sub-custodian was contractually entitled to charge the claimant’s account for the tax compensation amounts in question.

3.2.3. Reimbursement claim made abusively?

In addition, the Administrative Court raised the question of whether the reimbursement claim might be *abusive and against good faith* . The Court considered that the claimant must have been aware of the fact that, because of the specifics of the Swiss settlement and banking system, the buyers would (wrongly) be receiving full dividend statements with tax deduction certificates, which held the aforementioned

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damaging potential for the state. The tax compensation payments under dispute served to protect the state against such damaging potential.

3.2.4. Do Swiss banks have to abort the system of undue secondary withholding taxes?

Finally, the Administrative Court clarified that the "self-regulation" pursuant to SBA Circular 6584 was meant to safeguard the "evidential value" of the dividend statements including withholding tax deduction certifications being issued, pursuant to long-standing market practices in the interest of a functioning public share trading market. This mechanism ensures that it is and remains irrelevant for a buyer of shares cum dividend coupon whether the seller is long or short in the shares on the dividend payment date. Under any circumstances, the buyer may use the dividend statement to support a withholding tax reclaim (to the extent that the buyer principally qualifies for such a reclaim). On the other hand, the state would not suffer any financial damage. The banks may be tasked by the issuers with the execution of (net) dividend payments and the issuance of the necessary dividend statements to the beneficiaries. Given the lacking statutory basis, the FTA is not in a legal position to enforce this secondary withholding tax (the tax compensation) against the market participants. However, in the Administrative Court's opinion, for as long as the market participants comply with this secondary withholding tax regime on a "voluntary" basis, the FTA has no reason to stop this, and the FTA cannot be blamed for actively promoting that "regime" by providing a special reporting form (102M) for this secondary withholding tax to the market participants. The FTA does not need to care about who effectively pays these secondary withholding taxes, or who carries their financial burden. Principally, these secondary withholding taxes are not reimbursable by the state, unless there is solid proof that any over-refund or reimbursement of withholding would be excluded.

3.3. Judgment of the Federal Supreme Court

3.3.1. Are secondary withholding taxes imposed in accordance with applicable statutory law?

The FTA (and the sub-custodian, which had been invited by the courts as an ancillary party to the proceeding) kept representing that the secondary withholding taxes were genuine withholding taxes, due under article 4(1)(b) of the WHT Act. The Supreme Court had thus to decide (i) whether these were genuine withholding taxes falling under the federal WHT Act, and (ii) whether the amounts in question had to be reimbursed to the claimant.

The Supreme Court first considered that, if the secondary withholding taxes were real withholding taxes in the legal sense, the claimant would not be entitled to any refund or reimbursement. The Supreme Court considered that withholding tax on dividends is due by the debtor/payer of the taxable benefit, while it may be subsequently refundable to the beneficiary under certain conditions. In the event that the dividend compensation were to be treated as a taxable dividend, the claimant would be the debtor, and would as such not be eligible for any refund of the applicable withholding tax (only the creditor/beneficiary might potentially be eligible).

The Supreme Court pointed to the factual determinations made by the Federal Administrative Court, according to which the claimant had traded in equity-based futures and, in that context, engaged in short sales of Swiss shares cum dividend coupon. The shares needed to meet the delivery obligations towards the buyers and were procured before the customary delivery due dates, but still after the dividend payment dates. The aggregate volume of all short sales cum dividend had amounted to CHF 6.63 billion. The Supreme Court clarified that the claimant was not in a position to deliver the actual entitlement to, and benefit of, the dividends to the buyers, as it did not dispose of the shares on the dividend dates. Therefore, neither the claimant nor the buyers held an actual entitlement to the shares, and hence to the original dividends when they were paid. Therefore, the claimant could only deliver dividend compensations, rather than actual dividends to the buyers. The compensations were not rooted in any equity participation by the payer in the issuer of the underlying shares; they had no corporate law but only a contractual basis. Therefore, the Supreme Court confirmed the prior Court's conclusion that the compensations were not subject to statutory withholding tax.

3.3.2. May the short seller claim reimbursement of the undue taxes?

Also with regard to the question of whether the claimant was entitled to reimbursement by the FTA for the undue secondary withholding tax that had been submitted to the FTA and charged to the claimant's account by the sub-custodian, the Supreme Court essentially confirmed the considerations and conclusions of the Federal Administrative Court. In particular, the Supreme Court pointed to the regime provided by article 14 of the WHT Act, whereby the debtor of the taxable benefit has to pay the applicable withholding tax and, in particular, must charge the financial burden of the withholding tax to the beneficiary. Against that background, there is a general assumption of fact that the burden of the (albeit undue) withholding tax has been charged to the beneficiary of the dividend compensation. In such a situation, the undue withholding tax may be reimbursed to the person that has paid the undue tax to the FTA only, where it is certain that the beneficiary has not obtained any refund of the withholding tax through the ordinary refund procedure and that the reimbursement benefit will be transferred to the beneficiary (article 12(2) of the WHT Ordinance). That is the case because it is usually the beneficiary, rather than the payer, that is the ultimate "victim" of the payment of a withholding tax that is not actually due. The burden of proof for the fulfilment of these two conditions lies with the claimant. The Supreme Court confirmed the conclusion of the Administrative Court that the claimant had not provided any of the required evidence.

The Supreme Court acknowledged that the state may have been effectively enriched through the receipt of the secondary withholding taxes from the sub-custodian, to which it was not legally entitled as a matter of statutory tax law. However, the Supreme Court stressed (as the Administrative Court) that the FTA had no reason to reimburse those monies *to the claimant*: Only the claimant could have known the identity of the buyers in the short sale transactions, and those buyers presumably had been in a position to reclaim withholding taxes,

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as a matter of fact. Due to the mechanics of the dividend certification system in the market, the FTA was unable to determine whether those buyers had in fact received true dividends or only mere dividend compensations, and the claimant had not provided any of the evidence required under article 12(2) of the WHT Ordinance. Even if the state was enriched by the secondary withholding taxes, this was *not at the claimant's expense*. The Supreme Court considered that the claimant must have been well aware that it exploited the mechanics of the settlement system to effectively only deliver net dividend compensations to the buyers, although it had contractually undertaken to supply full dividends, while this would not be noticeable by the buyers, nor by the FTA, so the difference (equivalent to the 35% dividend withholding tax) would potentially be earned as an arbitrage profit at the expense of the federal government. The payment of the secondary withholding taxes by the sub-custodian to the FTA, while charging the claimant for it, only put the claimant back in the same position, as if it had performed its cum dividend sales to the buyers properly. Thus, the Supreme Court saw no basis for any reimbursement of the secondary withholding taxes to the claimant and confirmed the prior court's decision to reject the claim.

4. Comment

Although the economic outcome of the decisions rendered by the Federal Administrative Court and the Federal Supreme Court is understandable – it would not have been equitable to effectively allow market participants to earn tax arbitrage profits on the back of the Swiss federal government by systematically engaging in short sales cum dividend of Swiss equities on a large scale, thereby exploiting a "loophole" in the Swiss dividend certification system adopted by financial markets – the decisions effectively did not lead to the termination of the practice of imposing secondary withholding taxes on mere dividend compensations, which the courts themselves have confirmed not to be covered by applicable tax law. Such secondary withholding taxes are not only imposed – and systematically collected by the FTA – in practice with regard to dividend compensations made in cum-ex trading situations, but in addition also with regard to other compensations paid by Swiss-resident corporate entities to their counterparties with regard to Swiss dividend and bond interest coupons arising in securities lending and repo transactions, where such transactions extend over a coupon payment date. It would be desirable to effectively "close the loopholes" with legislation, which could include mere compensation payments for taxable dividends and bond interest payments as taxable objects for federal withholding tax purposes, rather than with mere administrative practices that do not pass the legality test. However, no such legislative proposal is in sight as yet.

Unlike in Germany, which has experienced similar tax issues emanating from cum-ex trades in German equity and debt securities, the author is not aware of any attempts thus far by the competent Swiss fiscal authorities including criminal prosecutors to pursue any parties that have attempted to avail themselves or other beneficiaries of undue Swiss withholding tax arbitrage benefits by systematically engaging in cum-ex trades of Swiss equity or debt securities criminally. Obtaining objectively undue federal withholding tax benefits for the perpetrator's own or someone else's benefit to the detriment of the state would principally meet at least the objective criteria of a punishable withholding tax evasion (article 61(c) of the WHT Act), which, if committed intentionally or negligently, is exposed to a financial penalty of up to CHF 30,000 or up to 300% of the undue tax benefit, or if the criteria of tax fraud in the meaning of article 14(2) of the Federal Act on Administrative Penal Law (APL) are met, a fine of up to CHF 30,000 or imprisonment of up to 1 year, or even up to 5 years plus a mandatory fine in particularly serious cases. In addition, unduly obtained withholding tax benefits may be reclaimed by the state from any direct or indirect beneficiary, where the objective criteria of tax evasion are met, regardless of any actual punishment of any perpetrator (article 12 of the APL). The applicable statute of limitation for the criminal prosecution and for the state's reimbursement claim is generally 7 years.

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