

## Swiss Federal Supreme Court issues decision on withholding tax reclaims on derivatives and beneficial ownership

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### Executive summary

In 2008, a United Kingdom (UK)-resident entity received a dividend distribution from shares it held in a Swiss entity. These shares had been acquired to hedge derivative contracts in the course of the UK-resident entity's standard business. Under the derivative contracts, a series of payments from the UK-resident entity to its clients were agreed. Inter alia, a settlement interest payment in the amount of withholding tax(es) levied was agreed, provided certain conditions were met.

The Swiss Federal Tax Administration granted a partial refund of withholding tax levied on the 2008 distribution and rejected the remainder of the reclaim.

The Swiss Federal Supreme Court was asked to determine whether the UK-resident entity could be seen as the beneficial owner of the Swiss dividend income, in which case the SFTA's decision to partially reject the claims would have been unfounded.

In addition to examining the validity of the claim's partial rejection, the Court examined whether a conduit arrangement had been put in place. The Court held that the settlement payment obligation in the case at hand must be qualified as a contractual obligation to forward the dividend payments in question. Such contractual obligation nullifies the UK-resident entity's beneficial ownership of the dividends received. The Court, therefore, upheld the partial rejection of the reclaim by the Swiss Federal Tax Administration.

## Detailed discussion

### Facts

In 2008, A Plc., a UK-resident entity which is part of a larger investment banking group, received a dividend distribution from shares it held in a Swiss entity (B shares). These shares had been acquired by A Plc. to hedge derivative contracts it had entered into with some of its clients under the ISDA Master Agreement, the standard contract published by the International Swaps and Derivatives Association used to govern all over-the-counter (OTC) derivatives transactions between parties. Such contracts were part of A Plc.'s standard business and did not constitute a deviation from said standard business. The derivative contracts' underlying was a notional share basket. Under the derivative contracts, A Plc. would make the following payments to the clients over the term of the contracts:

- ▶ Any value increases of the underlying notional share basket
- ▶ A settlement payment in the amount of the net dividends distributed by the issuing entity, i.e., in the case of Swiss shares, 65% of the gross dividend distributed by the Swiss entity
- ▶ A settlement interest payment in the amount of withholding tax(es) levied, provided certain conditions are met. These conditions are:
  - Such withholding tax(es) had been refunded to A Plc.
  - The sum of net dividends plus any refunded withholding tax(es) would be less than or equal to 80% of the gross dividend
  - The contracts state that where A Plc. received a refund of Swiss withholding taxes, it would be required to pay an amount of 15% of the gross dividend to its clients and keep 5% of the gross dividend for itself
- ▶ Interest on the collateral paid by the clients as well as a margin or a corresponding decrease in financing costs to be paid by the clients

In turn, the clients would be required to make the following payments to A Plc.:

- ▶ Any value decreases of the underlying notional share basket
- ▶ Interest payments (equal to the overnight interest rate)
- ▶ A margin, based on the value of the underlying notional share basket
- ▶ Repayable collateral of up to 25% of the underlying notional share basket's value

The contracts were designed as cash settlement only contracts with the settlement amounts being based on dividends received by A Plc. from the underlying notional share basket.

A Plc.'s counterparties in these derivative contracts were resident in the British Virgin Islands, the Cayman Islands and Cyprus.

A Plc., in a number of communications with the Swiss Federal Tax Administration (SFTA), set forth that no B shares were bought on or shortly prior to the dividend ex-date. In addition, where A Plc. sold B shares, it did not enter into any derivative contracts with its sale counterparties. Finally, A Plc. stated that it alone had received dividend distributions from B shares. The derivative contracts with its clients determined that a payment equal to 65% of gross dividends was to be made to the client by A Plc.

The SFTA granted a partial refund of Swiss withholding tax levied on the 2008 dividend distribution.

### Issues presented

Foreign-domiciled recipients of Swiss dividend payments may, based on an applicable double tax treaty, reclaim Swiss withholding taxes levied on Swiss dividend payments. Pursuant to article 10 (2)(b) of the double tax treaty between Switzerland and the United Kingdom (Swiss-UK treaty) in force at the time of the reclaims, a (partial) reclaim of Swiss withholding tax was possible where the beneficial owner of such income was resident in the UK. Hence, the court needed to determine whether A Plc. could be seen as the beneficial owner of the Swiss dividend income, in which case the SFTA's decision to partially reject the claims would have been unfounded.

### Key considerations for the Court

The following considerations are based on the Swiss-UK treaty in force at the time of the reclaims unless otherwise indicated.

In addition to examining the validity of the claim's partial rejection pursuant to article 10 (2)(b) Swiss-UK treaty, the Swiss Federal Supreme Court (SFSC) held that article 10 (6) in conjunction with article 3 (1)(I) Swiss-UK treaty (valid until 18 July 2019) was to be examined. Pursuant to article 10 (6) Swiss-UK treaty, withholding tax refunds cannot be granted where it is determined that a conduit arrangement has been put in place. Article 3 (1)(I) Swiss-UK treaty

contained the definition of “conduit arrangement.” Both of the aforementioned articles were repealed and replaced by article 27a Swiss-UK treaty in 2019 for any dividend income received as of 1 January 2020. The protocol introducing the concept of conduit arrangements entered into force on 1 January 2009. As the dividend in question was received in 2008, the conduit arrangement regulations were not yet in force. However, the concept of beneficial ownership and its relevance to determining a right to obtain withholding tax refunds has been contained in the Swiss-UK treaty since its inception. The specific articles on conduit arrangements are merely a clarification in connection with the concept of beneficial ownership. Therefore, they were considered in the SFSC’s analysis of A Plc.’s eligibility for treaty benefits.

In general, pursuant to the SFSC’s longstanding jurisprudence and practice, the “beneficial owner” is defined as the person who may fully benefit from the dividend payment and, consequently, may fully utilize such payment at their discretion. Where the recipient is restricted in the use of a dividend payment by either contractual or legal obligations to forward the dividend payment to another person, the original recipient’s beneficial ownership is negated.

Furthermore, where the recipient is economically obligated to forward such dividend payment (that is, the recipient is subject to a de facto obligation to forward the payment), beneficial ownership is also negated pursuant to the SFSC’s longstanding practice. Under this economic point of view, the payment of an amount generally equivalent to the received dividend would qualify as payment forwarding. It is—according to the SFSC—sufficient that the dividend amount is arithmetically contained in a total amount compensating not only the dividend payment but also such other risks and services as share price fluctuations or the payment forwarding itself. Therefore, the SFSC has held previously that payments equaling less than 100% of the dividend may still qualify as payment forwarding. The determination whether this is the case must be made using a substance over form approach, that is, the actual circumstances at the dividend payment date must be taken into account. In the case at hand, the SFSC confirmed that this practice continues to be valid and applicable.

Pursuant to the Organization for Economic Co-operation and Development’s (OECD) Model Convention and corresponding 2014 Commentary, a conduit entity is defined as an entity whose powers of decision are so narrow that, in effect, it

is merely a fiduciary or administrator acting on behalf on the parties concerned in relation to the dividend income. Therefore, its right to utilize a dividend payment is curtailed by its obligation to forward the payment or parts of the payment. For the OECD, a de facto obligation to forward the payment is not sufficient to negate beneficial ownership. Rather, the obligation must be of a legal nature but may result from a specific set of circumstances. The SFSC has clarified that its longstanding practice regarding de facto obligations to forward payments must be interpreted in line with the OECD’s Commentary on the Model Convention. As such, de facto obligations are indicative of the presence of contractual or legal obligations. Therefore, the SFSC’s longstanding practices in relation to obligations to forward payments are in accordance with the OECD’s Commentary.

In the case at hand, the settlement payment in the amount of the net dividends from shares in the underlying notional basket was to be made regardless of whether such shares were held by A Plc. and therefore regardless of whether a dividend had actually been received by A Plc. The settlement interest payment was only to be paid where: (i) withholding tax(es) had been refunded to A Plc.; and (ii) the net dividends plus any refunded withholding tax(es) were less than or equal to 80% of the gross dividend. In relation to Swiss shares, this meant a payment obligation in the amount of 15% of the gross dividend with such payment being dependent on A Plc. holding such shares. Based on the above, the SFSC determined an at least partial obligation to forward payments based on the contract documentation.

Objectively, a conduit arrangement is defined as a transaction or series of transactions structured in a way that the recipient of the income who would be eligible for treaty benefits pays all or most of said income to a person not resident in one of the treaty countries. Additionally, had such third person received the income directly, they would not have been eligible for treaty benefits either because no such treaty exists or they otherwise would not have qualified for such benefits or the terms of the applicable treaty would be less favorable than under the conduit arrangement.

As A Plc.’s derivative contract counterparties were resident in the British Virgin Islands, the Cayman Islands and Cyprus and neither of those countries had concluded a double tax treaty with Switzerland,<sup>1</sup> none of the counterparties would have been eligible for treaty benefits had they received dividends from B shares directly. However, where A Plc.

itself held B shares, met all requirements for a refund of Swiss withholding tax and forwarded such refund to its counterparties, the counterparties were put in a more favorable position. The SFSC, therefore, concluded that objective criteria of a conduit arrangement were met.

The subjective criterion of a conduit arrangement is the arrangement's main purpose. Where this main purpose is obtaining treaty benefits, the subjective criterion is met.

Pursuant to the Swiss-UK treaty, the claimant must satisfactorily prove its right to refund. It may thereby be expected that the claimant shows the economic reasons behind the arrangement in question where the objective criteria of a conduit arrangement are met.

The SFSC held that swap transactions cannot generally be qualified as tax optimization arrangements. However, where the payment modalities are such that they can reasonably only be explained with the obtaining of treaty benefits, their main purpose will be deemed to be the obtaining of treaty benefits.

The SFSC also held that the intended obtaining of treaty benefits in the case at hand was only possible if A Plc. acquired B shares to hedge against its settlement obligation under the derivative contracts. This was also supported by the financial incentives for A Plc. and its counterparties set by the derivative contracts. Although A Plc. was not contractually but rather only *de facto* obligated to acquire B shares and its counterparties could not legally force it to purchase such shares, the SFSC held that this was to be relativized. Had A Plc. not acquired B shares, it would have lost its entitlement to 5% of the gross dividend. Therefore, A Plc. was at least *de facto* obligated by the derivative contracts to purchase B shares. This, in turn,

strongly indicates a consensus between the involved parties that A Plc. would acquire B shares in order to provide its counterparties with the treaty benefits obtained pursuant to the Swiss-UK treaty. Where this holds true, A Plc.'s settlement payment obligation must be qualified as a contractual obligation to forward the dividend payments in question. Such contractual obligation restricts A Plc.'s use of such dividend payments from B shares and thereby negates its beneficial ownership of said dividends.

### The ruling

The SFSC dismissed the complaint filed by A Plc. and upheld the SFTA's (partial) rejection of the reclaim request(s) in dispute.

## Implications

While the SFSC has held that swap or derivative transactions are not generally detrimental to the refund of Swiss withholding tax(es) *per se*, it should be noted that arrangements involving (contractual) settlement payment obligations are subject to close scrutiny by the SFTA and, ultimately, the SFSC. Where a potential withholding tax refund must be forwarded wholly or in part to the claimant's counterparties, it is highly likely that the claimant's beneficial ownership of the dividend income will be questioned.

The decision rendered by the SFSC in this case is in line with decisions rendered in similar cases over the past three years, notably also in the SFSC decision on securities lending transactions dated 16 December 2019. It is expected that the SFSC will continue to uphold its jurisprudence and practice in connection with the concept of beneficial ownership.

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## Endnotes

1. The double tax treaty between Switzerland and Cyprus entered into force on 15 October 2015.

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