Swiss Supreme Court issues long-awaited decisions in the “Denmark” derivatives cases

Executive summary

On 5 May 2015, the Swiss Supreme Court issued decisions in two cases that have been pending since 2012. The cases involved two Danish banks that had entered into derivatives contracts over Swiss shares (total return swaps in one case and index futures in the other case). The banks also invested in the underlying Swiss shares in order to hedge their positions. The dividends on the Swiss shares were subject to withholding tax at 35%. The banks filed claims for full refund of the withholding tax under the Danish-Swiss double taxation agreement (treaty). The Swiss Supreme Court judged in favor of the Swiss Federal Tax Administration (SFTA) and confirmed the rejection of the withholding tax refund due to lack of beneficial ownership of the Danish banks.

Detailed discussion

The Danish banks saw their refund claims denied by the SFTA. The SFTA denied beneficial ownership of the Danish banks, considering that the dividends received were substantially passed on by the banks to their counterparties under the derivatives contracts, all of which were residents of third states which would not have obtained full refund of withholding tax. While a court of lower instance upheld the appeal filed by the Danish banks against the SFTA’s decision, the highest Swiss court has now decided in favor of the SFTA and has largely confirmed the current administrative practice of the SFTA.

The judges held along the following lines:

• There also is an implicit beneficial ownership requirement in treaties that do not explicitly mention beneficial ownership.

• Beneficial ownership requires, as a first element, that at the time of receiving a dividend, the recipient of a dividend has an unconstrained right to use, enjoy and dispose of the dividend received. If the recipient has a (legal or factual) obligation
to pass on the dividend received to a third party under a derivatives contract, beneficial ownership is denied.

• Furthermore, the beneficial owner must bear the economic risk of whether a dividend is distributed or not. Where such risk is passed on to a counter-party to a derivatives contract, beneficial ownership is denied.

• The derivatives contracts entered into by the Danish banks were accurately matching their investment in the underlying, both in volume and timing (the derivatives were entered into when the underlying shares were acquired, and were terminated when the shares were sold). At the time when the dividend was received by the Danish banks, they had an obligation to pass it on to third parties under the Total Return Swap or Futures contracts, so that both the risks and rewards of the investment in the Swiss shares were substantially with the third parties and not with the Danish banks, which made only a small profit from these transactions.

Implications

The SFTA will continue to apply its strict administrative practice and refuse refund of withholding tax in situations where they believe that the beneficial ownership is affected due to derivatives strategies. In order to get clarity over beneficial ownership, the current procedure with questionnaires and information requests is likely to continue. However, on the basis of the decisions of 5 May, it is expected that the SFTA will reach faster conclusions on granting or denying claims for refund.

The market for equity derivatives over Swiss shares will continue to languish, and the market will continue to price withholding tax refund right very low. However, there is now more clarity on the definition and interpretation of the concept of beneficial ownership in relation to derivatives strategies. Banks who issue derivatives over Swiss securities while being invested in the underlying should review the impact of the court decisions on their withholding tax refund claims.

For additional information with respect to this Alert, please contact the following:

Ernst & Young AG, FSO Tax, Zurich
  •  Rolf Geier      +41 58 286 44 94      rolf.geier@ch.ey.com
  •  Hans-Joachim Jaeger +41 58 286 31 58     hans-joachim.jaeger@ch.ey.com

Ernst & Young AG, FSO Tax, Geneva
  •  Christoph Suter +41 58 286 55 20     christoph.suter@ch.ey.com

Ernst & Young LLP, Switzerland Tax Desk, New York
  •  Thomas Semadeni +1 212 773 8442    thomas.semadeni@ey.com
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