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***By Electronic Delivery***

17 June 2016

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3003 Berne, Switzerland

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Bundesgasse 3
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Urs Duttweiler
Staatssekretariat für international Finanzfragen, SIF
Bundesgasse 3
3003 Berne, Switzerland

RE: *Swiss Withholding Tax on US CIVs*

Dear Ms. Schwendener, Mr. Duss, and Mr. Duttweiler,

The Investment Company Institute (ICI),[1] on behalf of its US members organized as regulated investment companies (RICs), requests a meeting to discuss treaty issues of industry-wide concern. The recent rejections by the Federal Tax Administration (FTA) of treaty refund claims filed by RICs, in our view, reflect an incomplete understanding of how RICs are organized, operated, and taxed. We propose to explain during the meeting why we believe RICs are entitled to receive the amounts claimed. We also would like to discuss how we can reach a mutually-agreeable procedure that is administrable for RICs and still ensures that only appropriate treaty relief is provided.

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[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's US fund members manage total assets of US$17.8 trillion and serve more than 90 million US shareholders. Members of ICI Global, the international arm of ICI, manage total assets of US$1.5 trillion.

This letter explains briefly:

1. the organization, operation, and taxation of RICs;
2. the ICI's discussions during 2000 and 2001 with the FTA to resolve the industry's treaty-eligibility issue;
3. subsequent developments with establishing treaty eligibility;
4. the current effective denial of treaty relief with respect to all shares held indirectly; and
5. why RICs are entitled to full treaty relief pursuant to the conclusions in a 2009 Organisation for Economic Co-operation and Development (OECD) Report and the 2010 Amendments to the OECD Model Income Tax Convention.

*The Organization, Operation, and Taxation of RICs*

RICs are collective investment vehicles (CIVs) similar to the Swiss funds, such as SICAVs and SICAFs, that are regulated under Swiss Collective Investment Schemes Act (CISA). Unlike Swiss funds, which are treated under Swiss law as transparent,[2] RICs are persons, residents, and the beneficial owners of their income under US law.

RICs are Widely Held Investment Vehicles

RICs are widely held, hold a diversified portfolio of securities, and are subject to stringent regulation under the Investment Company Act of 1940[3] and other US securities laws.[4] RICs typically have thousands of individual investors; some have hundreds of thousands. While the number of shareholder accounts in any one RIC is large, the size of the typical RIC account is relatively modest.[5] The amount of tax at issue for the average investor in a RIC that invests globally is considerably less. The cost to an individual RIC investor who sought to recover his or her proportionate interest in any excess tax withheld by a single country would be prohibitive.

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[2] http://www.sfama.ch/en/taxes/taxes-national/taxes-national

[3] 15 United States Code (U.S.C.) §§ 80a-1 *et seq.*

[4] *See,* the Investment Advisers Act of 1940 (15 U.S.C. §§ 80b-1 *et seq.*), the Securities Act of 1933 (15 U.S.C. §§ 77a *et seq.)*, and the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq.*).

[5] The most recent ICI data show median mutual fund assets of $103,000 per household in four accounts. http://www.icifactbook.org/fb_ch6.html, Figure 6.2.

RICs are Owned Almost Exclusively by US Persons

RICs, for both domestic and foreign tax and securities law reasons, are owned predominantly (if not exclusively) by US persons. The tax considerations discussed below generally make RICs non-competitive with non-US CIVs for non-US investors. The securities law considerations limit further any non-US investment in RICs.

RICs are subject to relatively unique domestic tax treatment that generally makes them unattractive to non-US taxpayers. Specifically, while non-US CIVs often retain ("roll up") their income without incurring any CIV-level tax, RICs effectively are required by US tax law to distribute essentially all of their income in the calendar year in which it is earned.[6] Thus, a non-US taxpayer will incur residence-country tax on all RIC distributions (as ordinary income from corporate dividends). If the non-US investor instead acquires interests in a non-US CIV, residence-country tax often will be deferred until the interests are sold (at which point preferential capital gains rates may apply).

Non-resident investors also incur US withholding tax on dividend income[7] received from their RICs because the U.S treats all RIC dividends as having a U.S source. Thus, a non-resident investor in a RIC will incur US tax on dividends attributable to the RIC's non-US investments (*e.g.,* equities issued by Swiss companies); no US tax would be incurred, in contrast, if the non-resident investor purchased shares of a comparable non-US CIV that made the same non-US investments.

Foreign securities law considerations also limit foreign investment in RICs. To ensure that a RIC is not treated as making a "public offering" in a foreign country, and thereby subjecting the RIC to foreign securities laws (some of which may conflict with US requirements), most RICs state in their offering documents that their shares may be purchased only by US persons. These RICs' broker distribution agreements include the same restrictions. These restrictions are so stringent that a RIC typically will refuse to allow any investor who moves from the US to another country to reinvest RIC dividends in additional RIC shares.

RICs Typically Will Not Know the Identities of Investors in Brokers' Nominee Accounts

RICs typically will know the identities only of those investors who purchase their shares directly from the RIC. For many RICs, the percentage of directly-held shares will be relatively low.

Many RICs rely extensively on unrelated parties (*e.g.,* financial institutions (FIs) such as broker dealers) to distribute RIC shares. These parties comply with all of the applicable know-your-

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[6] These rules are contained in Subchapter M (26 U.S.C. §§ 851 *et seq.*) and/or in section 4982 of the Internal Revenue Code.

[7] Under Code section 871(k), if a RIC elects to "flow-through" the character of interest income and short-term gains distributed as a dividend, a non-resident RIC shareholder will receive these amounts without incurring any US tax.

customer/anti-money-laundering requirements (including securing IRS Form W-9s from US persons); they also are responsible for all applicable US tax reporting and withholding requirements.

In general, FIs will not provide the RICs with any customer-specific information. Instead, all of the RIC shares for an FI's clients will be held on the RIC's books in a "street name" or "nominee" account in the FI's name. FIs establish street name accounts because they prevent the firms managing RICs, as potential competitors, from receiving highly sensitive and proprietary information regarding the identities of the FIs' clients.[8]

*The ICI's discussions during 2000 and 2001 with the Swiss Federal Tax Authority*

The ICI worked closely with the FTA in 2000 and 2001 to resolve concerns over the procedures under which RICs could establish their treaty eligibility. The ICI in November 2000 submitted the enclosed memorandum to the FTA explaining our view that, under Swiss law, RICs are the beneficial owners of their income; as this was the only treaty-eligibility requirement in dispute, RICs in our view were treaty entitled so long as they satisfied the treaty's (50% ownership) limitation on benefits provision.

The issue was resolved per the enclosed letter dated 10 July 2001 from the FTA's Eric Hess to the ICI's Swiss counsel. Although the FTA disagreed with our position that RICs beneficially own their income, they agreed that a RIC would be entitled to receive treaty-provided benefits on behalf of its shareholders. Under the agreed procedure, a full refund of all withheld taxes would be provided if more than 95% of the RIC's direct shareholders were US residents. Proportionate relief would be provided if the RIC's US shareholder percentage were below the agreed level. The agreed procedure further provided that if a RIC had *no* direct shareholders, the RIC would consult with the FTA an appropriate method for determining the US shareholder percentage.

Importantly, the RICs were required under the agreed procedure to use the documentation maintained for US withholding tax purposes (*i.e.,* the IRS Form W-9) to determine residence *only* for their direct shareholders. As we explained to the FTA, the RIC itself collects tax documentation only for those shareholders who acquire shares directly from the RIC. The practical impossibility of collecting tax documentation information from the distributors holding shares in nominee accounts was a critical factor in allowing RICs to determine US ownership based solely on directly-held shares.

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[8] This competitiveness consideration, the OECD has recognized, is not limited to RICs. Indeed, one of the primary drivers for the OECD's Treaty Relief and Compliance Enhancement (TRACE) project is a difficulty confronting custodian banks. Specifically, the banks have difficulty securing the necessary treaty-eligibility documentation from competing financial intermediaries in the chain of holders between the custodian filing the tax refund claims and the underlying securities owners who were treaty-entitled. *See* http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf.

The ICI agreed to this procedure on the industry's behalf because the directly-held shares of most RICs were at least 99% owned by US persons. Thus, in effect, Switzerland maintained its position that RICs were transparent, while the RICs recovered 100% of the treaty relief claimed under administrable procedures.

*Subsequent developments with establishing treaty eligibility*

Subsequently, the FTA modified the agreed procedure in various respects. The first change was that a RIC could not rely upon the US ownership percentage of its directly-held shares unless at least 50% of the RIC's shares were held directly. Over time, the required proof requirements were raised. Today, we understand, claims are being rejected even when the RIC provides precise customer-specific country-of-residence information purchased from a third party. This third party gains access to the distributors' customer-specific information so that the RIC and the distributors can meet their US securities law obligations to provide customers with specific information (including proxy solicitations). Importantly, the RICs do not know the identities of those persons whose shares are held indirectly. The RICs know, from the information purchased, only the portion of their shares that are held by residents of each specific country.

*RICs effectively are denied treaty relief today with respect to all shares held indirectly*

Our understanding is that RICs today are receiving refunds only for the portion of their shares held directly. Unless some mutually-agreed method of establishing the residence of indirect shareholders is reached, RICs effectively will be denied treaty relief for all shares held indirectly. We submit that the third-party information provided today – which is based upon the tax residence, but not the identities (unknown to the RIC), of a RIC's indirect shareholders – should satisfy the FTA's customer residency information requirement.

*RICs are entitled to full treaty relief pursuant to the conclusions in the OECD's CIV Report and the 2010 Amendments to the OECD Model Income Tax Convention*

CIV eligibility for treaty relief has been the subject of extensive discussion at the OECD over the past ten years. These discussions began with an Informal Consultative Group (ICG) formed by the OECD in 2006.[9] The ICG's conclusions were published in 2009 in a report entitled "The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles."[10] The next year, the

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[9] http://www.oecd.org/tax/treaties/oecdlaunchesprojectontaxationofcollectiveinvestmentvehicles.htm. The ICG was formed to develop both (1) a global understanding of the circumstances under which CIVs or their investors should be entitled to claim treaty benefits and (2) administratively feasible procedures to streamline claims for treaty benefits for all intermediated structures, including CIVs.

[10] http://www.oecd.org/tax/treaties/41974553.pdf. An FTA official (Sebastian Benz) was a member of the ICG.

ICG's conclusions were adopted by the OECD's Committee on Fiscal Affairs[11] and reflected in the OECD's 2010 Model Tax Convention Update.[12] Finally, the 2015 Final Report on BEPS Action 6 ("Preventing the Granting of Treaty Benefits in Inappropriate Circumstances") stated that "general support" remained for the CIV Report's conclusions.[13]

The OECD's entire CIV initiative has focused on identifying mechanisms by which CIVs, despite differences in how they are organized, operated, and taxed, recover appropriate treaty relief. As the OECD has noted, some CIVs are treaty-entitled in their own right as persons, residents, and the beneficial owners of their income. Other CIVs effectively should be provided treaty relief on behalf of their treaty-entitled investors. The relevant legal considerations are discussed in paragraphs 6.9 through 6.14 of the Commentary added by the 2010 Update to the OECD's Model Income Tax Convention.

RICs clearly are treaty-entitled in their own right under the Commentary. As we understand the present issue, there is no dispute regarding a RIC's status as a person or as a US resident.[14] The only dispute, we understand, involves the FTA's view that a RIC is not the beneficial owner of its income and therefore may claim treaty relief only to the extent of its US resident shareholders. In this regard, the ICI points to the beneficial ownership analysis performed by our Swiss counsel in 2000 and to the OECD's 2010 Commentary. Specifically, paragraph 6.14 of the Commentary provides that "a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof)." The claims filed by RICs are not based upon situations in which they are acting merely as agents for third parties.

Further, in paragraph 6.30, the Commentary suggests that "in many countries the CIV industry is largely domestic, with an overwhelming percentage of investors resident in the country in which the CIV is established. In some cases, tax rules discourage foreign investment by imposing a withholding tax on distributions, or securities laws may severely restrict offerings to non-residents. Governments

[11] https://www.oecd.org/tax/treaties/45359261.pdf.

[12] http://www.oecd.org/dataoecd/23/43/45689328.pdf. The 2010 Update to the Commentary on Article 1 of the Model Convention added twenty-seven new paragraphs.

[13] http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report_9789264241695-en#page1, paragraph 9.

[14] The US Treasury's Technical Explanation of the current double tax convention between the US and Switzerland provides, for example, that certain entities that" are nominally subject to tax but that in practice rarely pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs, REITs and REMICs are all residents of the United States for purposes of the treaty." *See* https://www.irs.gov/pub/irs-trty/swistech.pdf, page 11.

should consider whether these or other circumstances provide adequate protection against investment by non-treaty-eligible residents of third countries. It may be appropriate, for example, to assume that a CIV is owned by residents of the State in which it is established if the CIV has limited distribution of its shares or units to the State in which the CIV is established".

Paragraph 6.32 of the Commentary, in turn, suggests "[a]n alternative approach [that] would provide that a CIV that is publicly traded in the Contracting State in which it is established will be entitled to treaty benefits without regard to the residence of its investors. This provision has been justified on the basis that a publicly traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually exercise control over it."

*Conclusion and Request*

We submit that RICs clearly are treaty entitled as persons, residents of the US, and the beneficial owners of their income. Nevertheless, our primary concern is ensuring an administrable procedure by which RICs can establish their US ownership percentage. For all of the reasons discussed above, and as we will discuss when we meet with you, the residence information collected by an independent third party should be sufficient proof of the residence of a RIC's indirect shareholders.

* * *

Your consideration of this request and the important industry-wide issue that we raise is appreciated greatly. We look forward to discussing these issues with you in Bern. Please do not hesitate to contact me at your convenience (1-202-326-5832 or lawson@ici.org) if I can provide you with any additional information. You also may contact the ICI's Zurich-based counsel, Hans-Andrée Koch of Baker & McKenzie Zurich, at +41 44 384 12 01 or hans.koch@bakermckenzie.com.

Sincerely,

*/s/ Keith Lawson*

Keith Lawson
Deputy General Counsel – Tax Law

Enclosures

cc: Barbara Gertsch (Federal Tax Administration, Refund Department)
Hans-Andrée Koch (Baker & McKenzie)
Mary Bennett (Baker & McKenzie)

Eidgenössische Steuerverwaltung
Abteilung internationales Steuerrecht
z.Hd. Herrn Fürsprecher Eric Hess
Eigerstrasse 65
3003 Bern

ZURICH, November 7, 2000
Dokument13/76/fk

**Investment Company Institute**

Dear Mr. Hess

I refer to our meeting of July 12, 2000 and the letter of the Investment Company Institute dated March 23, 2000.

On the occasion of our above referenced meeting, it was agreed that I would examine in detail the issue of beneficial ownership with respect to RICs, for purposes of the Swiss-US Tax Treaty and that furthermore the Investment Institute would provide data with respect to the investments at issue.

Attached please find a memorandum which examines the issue of beneficial ownership of RICs with respect to capital earnings derived from Swiss securities. I come to the conclusion that a RIC must be considered as being the beneficial owner of the capital earnings deriving from the assets administrated by it and that furthermore RICs are resident in the US and entitled to treaty benefits as per article 22 of the Swiss-US Tax Treaty, that it is entitled to a partial refund of the Swiss withholding tax levied on dividends in accordance with article 10 § 2 of the Tax Treaty, respectively, to a full refund of

the Swiss withholding tax levied on interest in accordance with article 11 § 1 of the Tax Treaty.

Attached please also find the data collected by the Investment Company Institute among its members regarding investments in Swiss securities, the amount of tax claims as well as data relating to non US-shareholders of RICs. Their interest in RICs is, in the majority of cases, less than 1% so that it may be considered negligible. Even in the few cases where this threshold is exceeded, one cannot speak of a significant interest of non-US shareholders.

I would now kindly ask you to examine, in the light of the legal considerations in my memorandum and with a view to the above referenced data of the Investment Company Institute, whether the Federal Tax Administration may adhere to the view that RICs are entitled, under the Swiss-US Tax Treaty, to a partial refund of the withholding tax with respect to dividends, respectively, to a full refund of the withholding tax with respect to interest.

Needless to say that I shall be glad to meet with you any time you please.

Best regards,

Walter H. Boss

***Attachments***

# MEMORANDUM ON BENEFICIAL OWNERSHIP IN CONNECTION WITH RICs


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## I. Facts

A US investment fund is taxable under US tax law as a *regulated investment company (RIC)* if it meets certain requirements. A RIC is taxed as a US stock company on its income and gains, subject to specified tax reliefs. Importantly, in the process of establishing its taxable income a RIC is allowed to deduct the earnings distributed to its shareholders, if it distributes at least 90% of its taxable income (excluding capital gains) as well as 90% of the domestic tax-exempt interest earnings of the determined taxable year[1]. Unlike other US stock companies, a RIC must distribute virtually all of its taxable income and gains to shareholders each calendar year or pay an excise tax[2]. For the reasons discussed below, the overwhelming majority of the persons investing in RICs are resident in the US.

Various RICs hold, among others, capital investments in Switzerland. The capital earnings deriving therefrom are subject to the Federal withholding tax of 35%. The issue to be addressed is whether or not a RIC has the right to a full or partial refund of this withheld tax.

## II. Right to refund

According to the internal tax laws of Switzerland, a RIC is not entitled to receive a withholding tax refund. Pursuant to art. 21 § 1 lit. a of the Withholding Tax Act, a RIC cannot claim a refund of the Swiss tax withheld from its taxable earnings unless it is a Swiss resident (art. 24 § 2 Withholding Tax Act). This treatment applies regardless of whether the RIC had the beneficial right to receive the capital earnings on the tax-due date. Thus, one must examine whether the RIC is entitled to a full or partial refund of the withheld tax under the Swiss-US Income Tax Treaty (Tax Treaty).

The tax laws of Switzerland, as the source state, are *limited* pursuant to art. 10 § 2 of the Tax Treaty[3]. The withholding tax imposed in Switzerland on the dividends must not exceed 15% (or, for non-portfolio investors, 5%) of the gross amount of the dividends if the beneficial owner is resident in the US[4]. The question is therefore whether 20% or, respectively, 30% of the withholding tax imposed is to be refunded to a RIC.

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[1] Section 852 Internal Revenue Code of 1986 (IRC); RACHOFSKY/COHN/BAKER, 855.

[2] Section 4982(b) IRC; RACHOFSKY/COHN/BAKER, 858.

[3] Art. 7 § 7 of the Tax Treaty confirms that the dividend article applies, even if the dividend earnings of a RIC were to be considered business profits.

[4] In the following, the issue of beneficial ownership of a RIC is discussed only with respect to dividends and therefore only under art. 10 § 2 of the Tax Treaty. The same issues arise with respect to interest under art. 11 of the Tax Treaty, the only difference being that it is exclusively the state of residence who is granted a right to tax rather than both the state of residence and the state of source, in accordance with art. 11 § 1 of the Tax Treaty, given that the Swiss withholding tax on interest is fully refundable.

# III. Conditions for the Treaty Benefit

In order to be entitled to a refund in accordance with art. 10 § 2 of the Tax Treaty, a RIC receiving capital earnings must have the *beneficial right* to those earnings on the tax-due date as the owner of the underlying capital investments. Furthermore, the RIC must satisfy the "limitation on benefit" requirements of art. 22 of the Tax Treaty. The capital earnings do not have to be taxed in the resident state[5]. Thus, the tax reliefs granted to RICs in the United States do not influence the beneficial right of a RIC to its capital earnings under the Tax Treaty [6].

## A. General Conditions

### a. Residence

All US investment funds treated as RICs must, among other conditions, be taxable as US corporations[7]. RICs organized under US domestic law as corporations or business trusts meet this requirement[8]. Since all RICs are treated as corporations in the sense of art. 3 § 1 lit. b of the Tax Treaty and are therefore persons in the sense of art. 3 § 1 lit. a of the Tax Treaty, RICs are considered in the United States as persons subject to tax. Therefore, RICs are US-resident pursuant to art. 4 § 1 of the Tax Treaty.

### b. Beneficial Ownership

To answer the question of whether a RIC can be considered as *beneficial owner* of its portfolio assets, a discussion of the term *beneficial ownership* is necessary[9].

## B. LOB - Clause

### a. General

Art. 22 of the Tax Treaty provides specific requirements with respect to the residence of corporations. The purpose of this *limitation on benefits-clause* (LOB-clause) is to prevent *treaty shopping*[10]. Corporations having their seat exclusively or predominantly in a contracting state for reasons of obtaining treaty benefits are to be denied such benefits. Since this question has to be handled differently from case to case, art. 22 of the Tax Treaty lists a number of objective (and alternative) criteria to determine tax nexus. If one of these al-

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[5] SCHAUMBURG, 954; VOGEL, vor Art. 10-12 N 6.

[6] Vogel, vor Art. 10-12 N 10.

[7] Section 851(a) IRC; RACHOFSKY/COHN/BAKER, 853, 856 und 867.

[8] RACHOFSKY/COHN/BAKER, 853.

[9] Dazu nachfolgend IV.

[10] BOTSCHAFT DBA-USA, 1095; HESS, 178; LOCHER, internationales Steuerrecht, 146 und 375 f.; REINARZ, 12.

ternative criteria is satisfied, it is assumed that the corporation has a sufficient nexus to its state of residence and is therefore entitled to claim treaty benefits[11].

### b. Predominant-interest-Test

As previously mentioned and statistically verified, RICs are held almost exclusively by shareholders resident in the US[12]. This is a consequence of the tax disadvantages a non-US RIC shareholder suffers under US domestic tax law[13] and the limited offering of RIC shares for sale outside of the United States. It therefore can be concluded that RIC shareholders are typically persons with treaty beneficial rights, as defined under art. 22 § 1 lit. a, b, d, e or g. Thus, RICs meet the requirements of the predominant-interest-test (art. 22 § 1 lit. f) and are therefore fully entitled to treaty benefits in the sense of art. 22 of the Tax Treaty[14].

### c. Limited Derivative Benefits Test

RICs also may satisfy the limited derivative benefits test (art. 22 § 3) restricted to the treaty benefits determined by arts. 10, 11 and 12 of the Tax Treaty[15]. A thorough discussion of the corresponding conditions for this test is not necessary since the right of RICs to treaty benefits is established with the satisfaction of the predominant interest test.

# IV. Beneficial Ownership

## *A. General*

The Swiss-US Income Tax Treaty establishes in arts. 10, 11 and 12 the *concept of beneficial ownership* but provides no definition of this term. This concept follows the OECD model treaty (1977) which also does not define the term *beneficial owner.* The commentary pertaining to the OECD model treaty opines only to the effect that the limitation on the withholding tax must not apply if the receiver of the benefit is a third person intervening between creditor and debtor as, for example, an *agent* or a *nominee*[16]. Thus, the term "beneficial ownership" has as its purpose the avoidance of *treaty shopping*[17] where an entitled person intervenes as an agent on behalf of the not-entitled person so that the latter can then benefit from the treaty advantages [18]. Where a definition is lacking in a tax treaty, the opinions on whether the domestic law must be applied immediately or an interpretation

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[11] Botschaft DBA-USA, 1095; Hess, 178 f.; Lutz, 219; Rachofsky/Cohn/Baker, 863.

[12] Rachofsky/Cohn/Baker, 868.

[13] S. Rachofsky/Cohn/Baker, 859.

[14] S. Hess, 184 und 186 ff. sowie Lutz, 238.

[15] S. Lutz, 222 und 240 sowie Reinarz, 18 f.

[16] Kommentar OECD-MA, Art. 10 Ziff. 12; s. dazu Vogel, vor Art. 10-12 N 8.

[17] Schaumburg, 953 f.; Vogel, vor Art. 10-12 N 6.

[18] Kraft, 15; Schaumburg, 837; Vogel, Art. 1 N 83.

of the context in light of the general principles of international law is more appropriate, are controversial worldwide[19].

## B. Interpretation of Double Tax Treaty

According to almost unanimous Swiss doctrine and jurisdiction, a term not defined in the Tax Treaty has to be interpreted first by its *context* considering the general principles of interpretation of international law. An interpretation pursuant to the treaty context takes into account that double taxation treaties, in their function as connecting links between different legal systems and languages, use their own terminology[20].

The Swiss-US Income Tax Treaty contains in art. 3 § 2 a clause copied from art. 3 § 2 of the OECD model treaty which states that any term not defined in the Tax Treaty has the significance given by the applying state if the context does not intend something different. According to unanimous Swiss doctrine, this reference to the *lex fori* is only intended as *ultima ratio*[21]. The Federal Supreme Court (5th Chamber) has stated in one of its recent decisions that, in accordance with the principles of interpretation of international conventions in art 31 to 33 of the *Vienna Convention on the Law of Treaties of* May 23, 1969, the autonomous significance of the treaty provision has to be found. Only in cases where a treaty does not expressly or tacitly address a determined question is it appropriate to consult subsidiarily the terms and concepts of the applying state law[22]. Even in this case, however, an interpretation of the law following the provisions of the applying state according to art. 3 § 2 of the Tax Treaty is not appropriate because Swiss tax law does not contain any precise definition of the term *beneficial ownership*[23]. Were one to examine different sections of Swiss tax law where similar terms are used (e.g., the *right to benefit* in art. 21 § 1 lit. a of the Withholding Tax Act), the corresponding jurisprudence only may be helpful in discerning any potential, future interpretation of the term beneficial ownership under Swiss law[24].

## C. The Term "Beneficial Ownership" in the Tax Treaty Context

In consideration of the previous remarks, the term *beneficial ownership* will be interpreted according to the context of the Tax Treaty. An examination of "other evidence" in the Tax Treaty regarding the meaning of the term *beneficial ownership* may serve as a starting point. Further, when interpreting the term beneficial ownership as an anti-abuse measure in the Tax Treaty context, one must emphasize the substance of the ownership arrangement, not merely its legal form.

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19 LOCHER, internationales Steuerrecht, 122; OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, 312 ff.

20 LOCHER, internationales Steuerrecht, 124; s. dazu auch KRAFT, 21.

21 BGE 116 Ib 221; BLUMENSTEIN/LOCHER, 34; HÖHN, 83 ff.; LOCHER, Auslegung, 589; RIVIER, 103, ZIMMERMANN, 170.

22 BGE 117 V 268, 269 f.

23 OLIVER/LIBIN/VAN WEEGHEL/DU TOIT, 317; VOGEL, vor Art. 10-12, N 8.

24 LUTZ, 37; s. hinten C d.

### a. Connection between art. 22 and art. 10 of the Tax Treaty

One observes that the concept of beneficial ownership is not the only measure against treaty shopping abuses in the Tax Treaty. By means of the LOB-clause in art. 22, the general residence provisions of art. 4 concerning the persons entitled to Tax Treaty benefits are further restricted. Under the LOB-clause, Tax Treaty benefits should be denied to those companies having their seat in one of the contracting states exclusively for treaty benefit reasons[25]. Since it is often difficult to support the existence of an impermissible treaty-shopping motive in any particular case, art. 22 of the Tax Treaty provides different, objective (and alternative) tests to determine tax nexus. With the fulfillment of one of these tests, it is assumed that the company in question has a sufficiently close nexus to its state of residence to be entitled to tax treaty benefits[26].

Now, the question with respect to the relation between these two abuse provisions arises. In light of the limited OECD commentary regarding the term *beneficial owner* and the detailed anti-abuse provisions embodied in the LOB-clause of art. 22 of the Tax Treaty, one reasonably infers that the LOB-clause is intended as the primary mechanism to prevent treaty shopping abuses. One further infers that the concept of beneficial ownership in art. 10 of the Tax Treaty, or any tax treaty with a LOB-clause, is intended only to deny treaty benefits to receivers of capital earnings that are mere agents or nominees. Otherwise, one cannot comprehend the intended purpose of the beneficial ownership requirement[27]. This view regarding the intended interpretations of the LOB-clause and the term *beneficial owner* in the Tax Treaty is particularly appropriate given the doubts advanced by the tax law doctrine about the ability of a source state efficiently to administer the concept of beneficial right as an anti-abuse measure[28] and the considerable costs involved in attempting to do so[29].

### b. "Form versus substance"

If one takes, for purposes of the interpretation of the term *beneficial ownership*, the scope of avoiding treaty abuse, one must not put the emphasis on the formal legal ownership. It is instead decisive to know who is the *real* beneficiary rather than simply the formal owner. As a consequence, the person deciding on the investment of the capital assets or on the use of the capital earnings can be considered as beneficial owner[30].

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[25] BOTSCHAFT DBA-USA, 1095; HESS, 178.

[26] HESS, 179.

[27] Switzerland did not indicate any disagreement to this interpretation of the term beneficial owner by the OECD commentary.

[28] KRAFT, 23; LUTZ, 34.

[29] KRAFT, 22 f.; LUTZ, 34.

[30] KRAFT, 21; VOGEL, vor Art. 10-12 N 8 f.

### C. Administrative Practice and Jurisprudence with respect to Similar Terms in Domestic Tax Law

An examination of Swiss jurisprudence interpreting the term *right to benefit* is provided below for completeness' sake. As discussed previously, Swiss law should not control the interpretation of the term *beneficial owner* given the ample context provided for this purpose by the Tax Treaty and the lack of a precise definition of this term under Swiss law. If at all, Swiss domestic law might only be used subsidiarily in case the Tax Treaty itself were not to lead to a conclusive answer with respect to the proper interpretation of the term *right to benefit*. It has been shown above that this is not the case.

Art. 21 § 1 lit. a of the Withholding Tax Act refers to the term *right to benefit*. The Supreme Court examines the term *right to benefit* by means of different criteria. On the one hand, it considers the legal position under private law as the decisive criterion and establishes therefore the legal nature of the underlying relationship and the right to the capital gains which are subject to tax[31]. On the other hand, the Supreme Court looks at the *effective entitlement*. Thus, the right to benefit has to be denied if there is a legal obligation to forward the gross earnings or if it can be assumed that the capital earnings will not remain with the receiver[32]. Furthermore, the Supreme Court refers to the *purpose of the withholding tax*[33].

Another term similar to the right to benefit can also be found in art. 1 § 2 lit. a of the Federal Abuse Decree of December 14, 1962. Under these rules, tax reliefs are considered unjustified if the *right to benefit* as determined in the Treaty, which demands an unlimited right to benefit from the capital gains, is not established[34].

### *D. Regulated investment company as beneficial owner?*

Under a correct interpretation of the Tax Treaty, a RIC should be treated as the beneficial owner of the capital earnings from its portfolio assets under art. 10 § 2 because it is not a mere nominee or agent with respect to its shareholders. As a matter of form, the portfolio assets of a RIC are exclusively held in the name of the RIC and the RIC exclusively is entitled to exercise any voting rights with respect to those assets. As a matter of substance, shareholders of a RIC do not have any entitlement to income received by the RIC. A RIC retains discretion with respect to the declaration and payment of dividends to shareholders. Moreover, since a US investment fund can be taxed as a RIC only if it distributes at least 90% of its taxable income to shareholders, the RIC retains discretion regarding the use of

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[31] BGE 125 II 348, 349 ff.; 118 Ib 312, 313 ff.

[32] BGer vom18. Mai 1993, ASA 62 (1993/94) 705, 708.

[33] BGE 125 II 348, 352 ff.; BGer vom 18. Mai 1993, ASA 62 (1993/94) 705, 716 ff.

[34] Circular Letter of the Federal Tax Administration to the Cantonal Tax Administrations concerning measures against treaty abuse of December 31, 1962 ("Kreisschreiben der Eidgenössischen Steuerverwaltung an die kantonalen Steuerverwaltungen betreffend Massnahmen gegen die ungerechtfertigte Inanspruchnahme von Doppelbesteuerungsabkommen des Bundes vom 31. Dezember 1962", in: ASA 31 (1962/63) 247 ff., Ziff. 1).

its earnings almost per definition. Within its stated investment objectives, the RIC also is solely responsible for determining when to acquire and/or sell its portfolio assets.

Equally important, this interpretation of the term *beneficial owner* would not lead to treaty shopping abuse through RICs. RICs are almost exclusively held by shareholders resident in the United States for purposes of art. 22 of the Tax Treaty. RICs typically are not marketed for sale outside the United States. In addition, the unfavorable US tax treatment of non-US investors in a RIC would put most third-country investors holding Swiss securities through a RIC in a worse economic position than if they held the Swiss securities directly. For example, where a third-country investor resides in a country that has a tax treaty with Switzerland and also with the United States, a direct investment in a Swiss security would result in one level of Swiss withholding tax on dividends paid from the Swiss company to the investor. An indirect investment in that same Swiss security through a RIC would result in two levels of withholding tax – Swiss withholding tax on dividends paid from the Swiss company to the RIC and US withholding tax when the dividend from the Swiss company was paid through the RIC to the investor. Finally, tax on the earnings and realized gains of a RIC generally cannot be deferred by a non-US investor.

If, contrary to the conclusion reached above, Swiss law regarding the term *right to benefit* were applied to interpret the meaning of the term *beneficial owner*, a RIC also should be treated as the beneficial owner of the capital earnings from its portfolio assets under art. 10 § 2 of the Tax Treaty. For the reasons discussed above, a RIC exclusively holds the *right to benefit* from the capital earnings on its portfolio assets. A RIC also holds the *effective entitlement* to its capital earnings. In particular, a RIC determines in its sole discretion whether, and to what extent, to distribute or retain its capital earnings. While a RIC would pay less US tax at the entity level by making full distributions of its earnings, it is under no legal obligation to do so. Moreover, a RIC distributes its earnings to shareholders of record at the time the RIC decides to declare a dividend, whether or not those shareholders held an interest in the RIC when the underlying earnings were received. Finally, a RIC distributes its net earnings to shareholders (i.e., gross earnings reduced by operating and other expenses), not its gross earnings as contemplated under Swiss law.

## V. Conclusion

After a thorough discussion of the term *beneficial ownership*, the conclusion must be made that a US investment fund, taxed as a regulated investment company (RIC), has to be considered as the beneficial owner of the capital earnings derived from its portfolio assets. Furthermore, RICs are resident in the US (art. 4) and entitled to treaty benefits (art. 22) under the Swiss-US Income Tax Treaty. A RIC is therefore entitled to a refund of the withholding tax levied in Switzerland to the extent contemplated by art. 10 § 2 of the Swiss-US Income Tax Treaty.

Eidgenössisches Finanzdepartement
Département fédéral des finances
Dipartimento federale delle finanze

D S.US.62/D – Hes/Ast

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Eidgenössische Steuerverwaltung
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Ihr Zeichen / Votre signe / Vostro segno

Ihre Nachricht vom / Votre communication du / Vostra comunicazione del: 21. Juni 2001

Unser Zeichen / Notre signe / Nostro segno: D S.US.62/D – Hes/Ast
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Herrn Dr. Marcus Desax
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F: 11. Juli 2001 PLP
PK: 53/145

**Schweizerisch-amerikanisches Doppelbesteuerungsabkommen vom 2. Oktober 1996 (DBA-US 96); Rückerstattung der Verrechnungssteuer an amerikanische Regulated Investment Companies**

Sehr geehrter Herr Kollege

Ich nehme Bezug auf die Besprechung vom 21. Juni 2001 zwischen der Arbeitsgruppe „Collective Investment Vehicles" und dem Investment Company Institute (ICI).

Anlässlich dieser Sitzung wurde für die hängigen bzw. noch nicht eingereichten Rückerstattungsbegehren für die in den Jahren 1998-2001 sowie, auf Zusehen hin, für die in den Folgejahren abgezogenen Verrechnungssteuern die nachstehende Lösung ins Auge gefasst:

- Das ICI nimmt in Kauf, dass die ESTV im jetzigen Zeitpunkt daran festhält, dass RICs nicht als nutzungsberechtigte Empfängerinnen schweizerischer Kapitalerträge betrachtet werden.
- Die ESTV gewährt den RICs stellvertretend für die abkommensberechtigten Anteilsinhaber eine Entlastung der Verrechnungssteuer in dem durch das DBA-US 96 vorgesehenen Ausmass.
- Eine RIC teilt der ESTV den Prozentsatz ihrer Direktinvestoren sowie den Prozentsatz der von in den USA ansässigen Personen gehaltenen Anteile mit.
  Zu diesem Zweck ermittelt die RIC den US-Anteil ihrer Direktinvestoren aufgrund der für die Abrechnung mit dem IRS über die US-Quellensteuer zu führenden Dokumentation. Dieser Wert wird auf die Gesamtheit der Anteilsinhaber extrapoliert. Werden sämtliche Anteile einer RIC indirekt, d.h. über Broker gehandelt, kann die RIC den US-Anteil nach Rücksprache mit der ESTV auf andere Weise ermitteln.

(9)

- Übersteigt der ermittelte gesamthafte US-Anteil 97 % (Vorschlag ESTV) bzw. 95 % (Vorschlag ICI), wird die abkommensrechtliche Rückerstattung der RIC integral gewährt, wie wenn sämtliche Anteilsinhaber US-Personen wären. Liegt der US-Anteil unter diesem Schwellenwert, wird die Verrechnungssteuer lediglich anteilmässig erstattet.
- Die ESTV hat das Recht, die Richtigkeit der Angaben einer RIC stichprobenweise zu überprüfen.
- Für die die Jahre 1998-2001 betreffenden Anträge wird der US-Anteil wie hiervor beschrieben per 31. März 2001 ermittelt, für Folgejahre jeweils per 31. März des laufenden Jahres.
- Die ESTV wird zu gegebener Zeit ihre Praxis, RICs nicht als nutzungsberechtigte Empfängerinnen zu betrachten, überprüfen. Kommt sie zum Schluss, dass diese Praxis weiterhin aufrechtzuerhalten ist, kann sie auch den Schwellenwert für eine integrale abkommensrechtliche Erstattung anpassen oder, wenn sich hieraus Probleme mit anderen Staaten ergeben sollten, mit denen die Schweiz eine gegenseitige Vereinbarung über die anteilmässige Quellensteuererstattung an Anlagefonds getroffen hat, aufheben. Eine solche Änderung oder Aufhebung wird nicht rückwirkend vorgenommen.

Wir haben diesen möglichen Lösungsvorschlag vereinbarungsgemäss der Direktion der ESTV zur Genehmigung unterbreitet. Ich kann Ihnen nunmehr mitteilen, dass die Direktion der ESTV dieser Lösung - einschliesslich eines Schwellenwertes von 95 % - zugestimmt hat.

Mit freundlichen Grüssen

EIDG. STEUERVERWALTUNG
Abteilung für internationales Steuerrecht
und Doppelbesteuerungssachen

E. Hess

Swiss Federal Tax Administration
Berne, July 10, 2001

Mr. Marcus Desax
Pestalozzi Lachenal Patry

Re: Swiss-U.S. Double Taxation Convention of October 2, 1996 (DTC-US 1996); Refund of Withholding Tax to Regulated Investment Companies

Dear Colleague:

Reference is made to the meeting of June 21, 2001, between the working group "Collective Investment Vehicles" and the Investment Company Institute (ICI).

At this meeting the following solution was considered for the pending, respectively yet to be filed, requests for refunds for the years 1998-2001, as well as, for the time being and until further notice, for the tax to be withheld in the subsequent years:

- ICI assumes the consequence that the FTA, for the time being, maintains its position that RICs may not be considered as beneficial owners of Swiss capital income.
- The FTA grants to the RICs, as representatives of the shareholders, that are entitled to treaty benefits, the refund of the withholding tax to the extent provided in the DTC-US 1996.
- A RIC informs the FTA of the percentage of its direct investors as well as of the shares held by persons resident in the USA. For this purpose, the RIC determines the U.S. share of its direct investors on the basis of the documentation that it must maintain for the accounting to the IRS for U.S. withholding tax. This value is extrapolated to the totality of shareholders. In the event that all shares are traded indirectly, i.e., through brokers, the RIC may, after consulting with the FTA, determine the U.S. shares by other means.
- If the ??-determined total U.S. share exceeds 97% (proposal FTA) ?? 95% (proposal ICI), the refund according to the treaty will be granted to the RIC integrally, as if all shareholders were U.S. persons. If the U.S. share is below this threshold, the withholding tax will be refunded on a pro rata basis only.
- The FTA has the right to check the accuracy of the statements made by a RIC on a random basis.
- For the claims for refund pertaining to the years 1998-2001 the U.S. share will be determined, as described above, as of March 31, 2001, for the subsequent years as of March 31 of the current year.

- The FTA will, at a given time, re-examine its position to treat RICs not as beneficial owners. If it reaches the conclusion that its practice ought to be maintained, it may also adapt the threshold for the integral refund pursuant to the treaty, or do away with a threshold if problems should arise therefrom with respect to other countries with which Switzerland has reached agreement on a pro rata refund of withholding taxes to investment fund. Such change or **??** will not be made retroactively.

We have submitted this possible proposal for solution to the Director of the FTA. I can inform you that he has approved this resolution, including the threshold of 95%.

Sincerely,

FTA
Division of International Tax and Double Taxation
E. Hess