Key Aspects of the Challenges of Tax Compliance Management

BY IFZBLOG ON 27. JULI 2017ALLGEMEINES, COMPLIANCE MANAGEMENT, WEITERBILDUNG


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Over the last years, Tax Compliance Management has become a key topic for financial institutions around the globe, including Switzerland. In an increasingly demanding tax and regulatory environment, the introduction of new tax rules has created a wide range of complex requirements for financial institutions. The pressure on financial institutions to comply with these new requirements and to manage financial and reputational risks is significant.

Specifically, tax compliance management for financial institutions focuses on the three relevant levels. The first level, the tax requirements for the financial services providers, focuses on the tax implications at the level of the financial institution itself, i.e. to fulfil the financial institution's tax and regulatory obligations. At the second level, the focus is on the duties the financial institution has towards its clients, including collecting and paying clients' taxes as well as collecting customer information to ensure compliance with regulatory requirements and tax transparency. The third level concerns the adaptation of products and services offered by financial institutions to market demands, i.e., to meet customers' demands for services such as tax-optimized discretionary mandates, specific country tax reports, tax reclaim support and information on voluntary disclosure programs.

Knowing and being able to handle risks connected to these compliance obligations became key for any financial institution. This is particularly important for those financial institutions that offer complex financial instruments and structured transactions to their clients, such as hedged equity transactions involving swaps or other derivative financial instruments, or are involved in such transactions. Tax authorities have focused their efforts in reviewing and challenging such transactions.

Tax Risks and Challenges for Financial Institutions Offering Complex Financial Instruments and Structured Transactions

Financial institutions offering complex financial instruments have been subjected to strict scrutiny by the Swiss tax authorities. In particular, the Swiss tax authorities have centered their attention on hedged equities transactions with Swiss equities held over dividend record date, and have subjected financial institutions involved in such transactions to withholding tax risks. The basic mechanism of such hedged equities transactions is as follows:

A financial institution purchases Swiss equities cum dividend before the ex date (physical long position) and hedges its long position by selling derivative financial instruments such as total returns swaps, futures or call/put option combinations over the same Swiss equities (synthetic short position). As a result of the fully hedged position, the financial institution is not exposed to the market risk of the Swiss equities. The financial institution receives the net dividend paid on the Swiss equities and claims a refund of Swiss withholding tax. The financial institution may benefit from a better withholding tax refund position than the seller of the Swiss equities. At maturity, the financial institution sells the Swiss equities (ex dividend) and closes out the hedging transaction.

Recently, however, the Swiss Federal Supreme Court has ruled that as a result of a harmful obligation to pass on the dividend income, the financial institution may not be entitled to a refund of Swiss withholding tax since the financial institution does not meet the beneficial ownership requirement. Generally speaking, there is a harmful obligation if both (i) the realization of the dividend income is legally or factually dependent on the obligation to pass on this income (first dependency); and (ii) the obligation to pass on the dividend income is legally or factually dependent on the realization of this income (second dependency and, together with the first dependency, the so called concept of interdependence).

In light of the Swiss Federal Supreme Court case law, financial institutions with pending Swiss withholding tax refund claims associated with supposed dividend arbitrage transactions find it difficult to obtain tax refunds. This has also led to legal uncertainty for market participants, such as liquidity providers or brokers. However, every case has to be reviewed and assessed based on its own merits.

Conclusion on Tax Risk Mitigation for Financial Institutions

The complexity of the regulatory framework and the consequences of non-compliance show that financial institutions must ensure compliance with these regulations by constantly updating their processes and training their employees. It has become vital to address such challenges along the three relevant levels of tax compliance, namely at the financial institutions' level, the clients' tax duty level, and the financial products and services level.

In response to this demand, the **Institute of Financial Services Zug IFZ** has launched the second edition of the **CAS Tax Compliance Management for Financial Institutions** course. This course provides participants with specific skills on tax compliance management related to financial service providers.