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How collective investment schemes are taxed

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How collective investment schemes are taxed

Rolf Wüthrich of VISCHER explains that new legislation has increased Switzerland's appeal as a location for this kind of financial instrument

The Swiss Federal Act on Collective Investment Schemes and the Federal Ordinance on Collective Investment Schemes have been in force since January 1 2007. This legislation is supplemented by the FINMA (the Swiss Financial Market Supervisory Authority) Ordinance on Collective Investment Schemes and by FINMA circulars, while self-regulatory rules adopted by industry organisations may be recognised by the FINMA as a minimum standard. Based on these new regulations the Swiss Federal Tax Administration has issued Circular Letter No 24 of January 1 2009 regarding withholding tax and stamp duty and Circular Letter No 25 of March 5 2009 addressing the income tax consequences of collective investment schemes.

The entry into force of the CISA (the Federal Act on Collective Investments) has extended the scope of the legislation to cover also collective investment schemes in corporate form (investment companies with variable capital [*Société d'investissement à capital variable*, SICAVs], investment companies with fixed capital [*Société d'Investissement À Capital Fixe*, SICAFs] and limited partnerships for collective investments). Additionally, the protection accorded to investors now reflects their differing needs in that it distinguishes between "ordinary" and "qualified" investors.

Under Swiss investment fund law, an investment fund is defined as being a pool of assets raised from investors as a result of public advertising for the purpose of collective investment, and managed by the fund management company for the account of the investors in accordance with the principle of risk diversification. Hence only funds established on a contractual basis or as a SICAV are permitted as open-end collective investment schemes in Switzerland. Closed-end collective investment schemes take the form of a limited partnership for collective investments or a SICAF. As regards domestic investment funds, Swiss fund legislation draws a distinction between (i) securities funds (harmonised with the European fund directive), (ii) real estate

funds and (iii) other funds for traditional and alternative investments.

Open-end or closed-end collective investment schemes which preview in their basic documents distributions of at least 70% of the yearly net income, including profits carried forward, are considered as distributing investment schemes. Schemes, which do not preview such a distribution clause, are considered to be accumulating investment schemes.

FINMA grants licences and approvals

SICAVs and limited partnerships for collective investments is subject to Swiss withholding tax of 35%

required under the CISA and monitors compliance with legislative, contractual, constitutive and regulatory provisions. It distinguishes between the concepts of licence and approval. Institutions that are subject to supervision require a licence, while the documents of collective investment schemes that are subject to supervision require approval. Any person or institution that manages or acts as custodian for collective investment schemes requires a licence from FINMA. This includes:

- fund management companies;
- SICAVs;
- limited partnerships for collective investments;
- SICAFs;
- custodian banks;
- asset managers of Swiss collective investment schemes;
- distributors; and
- representatives of foreign collective investment schemes

Asset managers of foreign collective investment schemes can apply voluntarily for a licence from the supervisory authority.

These basic documents for collective

investment schemes require FINMA approval:

- the collective investment agreements of investment funds;
- the articles of association and investment regulations of SICAVs;
- the partnership agreements of limited partnerships for collective investments;
- the articles of association and investment regulations of SICAFs;
- the corresponding documents of foreign collective investment schemes.
- Because of their dual nature, SICAVs, SICAFs and limited partnerships for collective investments require both a licence as an institution and approval for their product or products.

This article does not describe the exact treatment of specific investment products or investment schemes, but shall give an overview of the applicable concepts. For specific investments it is important to consider carefully the rules described in the circular letters.

Income tax treatment of collective investment schemes

When setting up a contractual collective investment scheme, a SICAV or a limited partnership for collective investments, the investment scheme must be registered with the Federal Tax Administration before the first participations are issued. The basic documents of the investment scheme must be filed with the tax administration. Every future modification of the basic documents must be announced to the administration.

Collective investment schemes without direct possession of real estate

Following the fiduciary concept the CISA considers collective investment schemes as transparent. This means that collective investment schemes manage funds on account of the investors and, as a consequence, the investment schemes are not liable to tax on income realised from the investments under management. Both, assets under management as well as profits resulting here out are allocated directly to the investors. Thus, neither contractual col-

lective investment schemes, SICAVs nor limited partnerships for collective investments are subject to taxation in Switzerland, unless the scheme is a collective investment scheme with direct possession of real estate. SICAFs, however, are treated as legal entities and are therefore non-transparent for tax purposes.

Collective investment schemes with direct possession of real estate
Not only contractual investment schemes, but also SICAVs and limited partnerships for collective investments may also have direct possession in Swiss real estate. Open collective investment schemes must have stakes in at least 10 real estate projects.

Collective investment schemes with direct possession of Swiss real estate are subject to tax in Switzerland on profits and gains resulting from the real estate. For profits not related to such real estate (for example, interest) the collective investment scheme is not subject to tax. Such profits are taxed in the hands of the investors (transparent treatment).

Income tax treatment of investors

For the qualification of income as income from investment schemes it is crucial that the asset managers or the governing bodies of a SICAV or of a limited partnership for collective investments are acting independently from the investors and that the investors do not have any decision-making powers over such bodies.

Only a person that has unlimited liability to tax in Switzerland is subject to Swiss income tax, in principle, Non-Swiss investors are therefore not subject to tax in Switzerland on their income realised from Swiss collective investment schemes (unless they participate in the investment scheme by use of a Swiss permanent establishment). Thus, assets and income are only taxed directly at the level of the investor on the basis of the provisions applicable in the investor's tax domicile. Income of a collective investment scheme realised by an investor includes distributed as well as accumulated income (for example, interest or dividends). Distributed or accumulated capital gains are, from a Swiss point of view, tax free if they are accounted for separately in the financial statements if the investment scheme or if they are distributed by way of a separate coupon.

Withholding tax

Levy of Swiss withholding tax
Income from accumulating and from distributing contractual collective investment schemes, SICAVs and limited partnerships

for collective investments is subject to Swiss withholding tax of 35%. Capital gains, income from the direct possession of real estate as well as repayments of investments are exempt from withholding tax. In the case of capital gains, withholding tax must not be levied if the gains are accounted for separately in the financial statements of the investment scheme and, in case of distributing schemes, if they are distributed through a separate coupon. Distributions by SICAFs are subject to Swiss withholding tax.

The withholding tax is due at the moment of the allocation (credit) of the taxable income to the investor or, in the case of a liquidation, at the moment of distribution of the liquidation proceeds. The withholding tax must be paid to the tax administration within 30 days from the due date.

Swiss withholding tax refund

A refund for deducted withholding tax is granted if the requesting investor was the beneficial owner of the income subject to withholding tax and, in case of a cross-border situation, the requirements of the applicable tax treaty are fulfilled.

Affidavit

If more than 80% of the taxable income of a collective investment schemes derives from sources outside of Switzerland, then Swiss withholding tax has to be levied on payment (or credits in case of accumulating schemes) of the investment scheme to its non-Swiss investor, subject to the existence of an affidavit (declaration of domicile). To prove that the 80% non-Swiss income threshold is reached, the investment scheme must keep different accounts for Swiss and non-Swiss sourced income. The administration has issued a list containing the institutes authorised to issue affidavits. Affidavits may only be issued to non-Swiss persons who are in the legal position to request for a refund of the Swiss withholding tax. No affidavit is issued for Swiss permanent establishments of non-Swiss entities.

Foreign withholding taxes

As Swiss tax treaties may only be applied to persons subject to unlimited tax liability in Switzerland, contractual collective investment schemes, they are not applicable to SICAVs and limited partnerships for collective investments. However, some recently concluded or amended treaties contain special provisions stating that contractual collective investment schemes, SICAVs and limited partnerships for collective investments can apply the reduced withholding tax rates under the applicable tax treaty for income allocable to Swiss residents. Therefore, the investment scheme must be

able to show the ratio of Swiss to non-Swiss investors at the moment of income distribution or accumulation, as the case may be.

Special aspects

Accumulating and mixed collective investment schemes

In case of transparency the income of a collective investment scheme is subject to tax in the hands of the investors. The accumulating investment schemes must therefore issue on a yearly basis a confirmation to the investors showing all accumulated profits. Not subject to confirmation are reinvested capital gains if such gains are accounted for separately in the financial statements of the investment scheme.

If a distributing collective investment scheme decides, based on a corresponding provision in its basic documents, not to distribute any income, it will not be re-qualified into an accumulating collective investment scheme if the following conditions are met: (i) the net income of the current business year as well as income carried forward amounts to less than 1% of the net asset value of the investment scheme and (ii) the net income of the current business year as well as income carried forward, amounts, per participation, to less than SFr1, \$1, €1, £1 or ¥100. In this case, however, undistributed income realised must be booked as income carried forward and may not be distributed in the following business year. As a consequence, no tax issues arise. Only with the next distribution the profits carried forward will, from a Swiss point of view, be subject to tax at the investor level.

Distributed and accumulated income of mixed collective investment schemes are subject to income tax in the hands of the investors at the moment of distribution or accumulation, as the case may be. At the same time withholding tax is due.

Participation exemption

Swiss stock corporations as well as limited liability companies holding participations in contractual investment schemes, SICAVs or limited partnerships for collective investments may not apply for the Swiss participation exemption applicable to dividend income when it is received from such investments. The participation exemption will avoid double taxation. As the investment schemes mentioned are considered transparent, no double taxation results as the income in question is only taxed in the hands of the investor and, as a consequence, the application of the participation exemption is therefore denied.

The participation exemption may, however, be applied to income received from a

participation in a SICAF as SICAFs are considered not to be transparent.

Funds-of-funds schemes

In the case of fund-of-funds schemes investors invest into a so-called master fund; the master fund (feeder) will then invest into various other collective investment schemes (target funds). To qualify as master fund, investments in at least five target funds must be made by the master fund. Depending on the investment strategy of a target fund a master fund may realise different types of income. The Swiss or foreign target funds are considered to be transparent and the income realised by the target funds is allocated to the master fund, subject to the fulfilment of these conditions:

- The master fund is a Swiss contractual investment scheme, SICAV or limited partnership for collective investments;
- In its basic documents a target fund has stipulated as investment strategy the realisation mainly of capital gains;
- From each target fund not more than 2% of the total net asset value of a collective investment are realised; and
- The master fund is reporting annually about its investment in target funds.

Target funds fulfilling the 2% net assets value threshold do keep their qualification for a period of five years.

If these requirements are fulfilled, then a master fund can book its total income from the target funds as capital gains. The Federal Tax Administration reserves the right to review the investment structure of a master fund.

Non-Swiss collective investment schemes

Non-Swiss collective investment schemes are treated as equal to Swiss collective investment schemes for tax purposes if the non-Swiss schemes fulfil one of these requirements:

- The foreign investment scheme is granted a licence by FINMA; or
- The foreign investment scheme is under supervision of a recognised non-Swiss supervisory body; or
- The foreign investment scheme is an open investment scheme on contractual or corporate basis with the purpose of collective investments, such a scheme has its seat outside Switzerland and the investors have a claim against the investment scheme on repayment of their part of the net asset value; or
- The foreign investment scheme is a closed investment scheme on contractual or corporate basis with the purpose of collective investments and the scheme has its seat outside Switzerland



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Reorganisations, liquidation and expatriation of collective investment schemes

Reorganisations

Contractual investment schemes may transfer their assets and liabilities to other funds. Under Swiss merger law SICAVs may implement the following reorganisations measures:

- Merging with Swiss investment funds or SICAVs;
- Transferring assets of foreign collective investment schemes to Swiss SICAVs; and
- Transferring assets of Swiss investment funds to foreign collective investment schemes.

As the reorganisations must take place at fair market value, no Swiss income tax consequences arise in Switzerland from such reorganisations. Depending on the implemented reorganisation, different withholding tax consequences may apply which should be clarified in detail for each specific case before a reorganisation is implemented.

Liquidation of collective investment schemes

For Swiss income tax purposes, the repayment of invested capital, as well as of capital gains, is tax neutral for individuals. Liquidation proceeds in excess of the invested capital (and capital gains) are subject to income tax, to the extent such liquidation proceeds were not already taxed in the past. For Swiss companies, the difference between the book value of the investment and the realised liquidation proceeds is subject to taxation.

Ninety percent of the liquidation proceeds may be distributed immediately. The distribution of the remaining 10% is only allowed after the receipt of the approval by the Federal Tax Administration. The tax administration supervises the liquidation by reviewing these documents:

- audited liquidation balance sheet and financial statements;

- the financial statements of the current business year until the liquidation date; and
- the draft of the information letter regarding the final payment to the investors.

Expatriation of collective investment schemes

The expatriation of a collective investment scheme outside of Switzerland does not trigger any Swiss income tax consequences if the scheme is considered to be transparent. However, for withholding tax purposes the expatriation is considered to be a liquidation, which triggers withholding tax on the net income and possible income carried forward.

Similar to Europe

The enactment of the CISA has brought Swiss legislation in line with the EU funds directive UCITS (Undertakings for Collective Investments in Transferable Securities), strengthening the country's competitiveness as a location for collective investment instruments. The aims of the CISA are to protect investors and to ensure the transparency and functionality of the market. It regulates open-end and closed-end collective investment schemes. The CISA is designed as a framework law and focuses solely on providing basic regulations.

Based on the CISA the Federal Tax Administration issued Circular Letter No 24 of January 1 2009 regarding withholding tax and stamp duty and the Circular Letter No 25 of March 5 2009 addressing the income tax consequences of collective investment schemes. The two circular letters implement the necessary modifications due to the new CISA and regulate in detail domestic as well as international tax aspects regarding the treatment of collective investment schemes and income realised in the future. Furthermore, administrative rights and obligations are defined to ensure a smooth handling of tax issues with respect to collective investment schemes.

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