

How taxation of collective investments affects investors

Switzerland has worked hard to attract fund management. It should reform its withholding tax provisions if it wants to get the most out of this investment, argue Roger Dall'O & Monika Gammeter Utzinger of Tax Partner – Taxand

On January 1 2007, the new Federal Act on Collective Investment Schemes (CISA) came into force in Switzerland. Based on the new statutory regulations in the CISA the Swiss Federal Tax Administration issued Circular Letter No 24 of January 1 2009 about withholding tax and stamp duty consequences for collective investment schemes and Circular Letter No 25 of March 5 2009 covering income tax for investors of collective investment schemes. The applicable tax regulations were revised to set the fiscal framework for the newly introduced types of collective investment vehicles by the CISA: the investment company with variable capital (*Société d'investissement à capital variable*, SICAV), the limited partnership for collective investment (LPCI) and the investment company with fixed capital (*Société d'investissement à capital fixe*, SICAF).

While Switzerland is one of the primary markets for asset management and the distribution of collective investment schemes in Europe, it is still a niche market as a production location. Hence, it was one of CISA's major aims to encourage the use of Switzerland as a set-up location for collective investment schemes. To date, this aim has not been achieved, and the financial crisis and the Madoff scandal had a major impact on the Swiss market for collective investment schemes.

Looking at the fiscal conditions, one of the major tax issues keeping Switzerland from ranking as one of the top locations for collective investment schemes is the Swiss withholding tax, which is, in general still applied on the distribution and the accumulation of income of Swiss collective investment schemes. Another relevant topic from a tax perspective is the taxation of a fund manager's carried interest. In late 2008 the Swiss Federal Department of Finance announced a circular on the favourable taxation of fund managers. These measures were meant to make Switzerland even more attractive as a location for hedge funds by clarifying the taxation of performance fees and carried interest. For political reasons the circular

has never been published and only a draft is available.

Tax treatment of Swiss collective investment schemes

Income tax – Fiscal transparency

In principle, contractual investment funds, investment companies with variable capital (SICAVs) and Swiss limited partnerships for collective investment (LPCI) are regarded as transparent for tax purposes. These investment vehicles are in general not subject to Swiss profit and equity taxes and income is consequently taxed at the level of the investors. The concept of transparency was already applied under the previous Investment Fund Act for contractual investment funds. The taxation for the recently introduced SICAVs and Swiss limited partnerships for collective investment is based on the principle "same business, same rules".

On the contrary, SICAFs and collective investment schemes with direct property holdings do not benefit from the transparency principle and are taxed as legal entities. Although for collective investment schemes with direct property holdings the applicable federal tax rate is half of the ordinary corporate income tax rate, the cantonal and municipal tax rate depends on the canton in which the property is situated.

Withholding tax

Income generated by contractual investment funds, SICAVs and limited partnerships for collective investment schemes is subject to withholding tax of 35% whether or not the income is distributed. Capital gains and income generated by the fund through 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 capital gains are accounted for separately in the financial statement of the collective investment scheme and, in the case of distributing collective investment schemes, if the capital gains are distributed with separate coupons. Distributions by SICAFs are, in general, subject to withholding tax.

With the introduction of the CISA the legislature introduced a significant change of system in the withholding tax area. In the past, income from accumulating funds was only subject to withholding tax at the moment of redemption by the investor or liquidation of the fund. Since January 1 2007, reinvested earnings are subject to withholding tax at the moment of accumulation, that is, at the end of the financial year of the fund. Levying withholding tax on earnings of accumulating funds at the point of reinvestment of the income is disadvantageous for the international attractiveness of Swiss accumulating funds. Instead of strengthening Switzerland's role as a fund centre by abolishing withholding tax on collective investment schemes, as many specialists have demanded, the legislature decided to introduce a detrimental withholding tax regime for Swiss accumulating investment funds. Since other leading centres for investment funds do not levy any withholding tax on collective investment schemes, many of the few existing accumulating investment funds have relocated in the meantime or were changed into distributing funds.

For non-Swiss resident investors, distributions and reinvestments from collective investment schemes which generate at least 80% of their income from foreign sources, are not subject to a deduction of withholding tax and may make use of the affidavit procedure.

Swiss residents may claim a refund of withholding tax deducted if they are the beneficial owner of the shares in the collective investment scheme and have declared the income from their shares in the collective investment scheme in their tax return. A non-Swiss resident investor can claim a reduction of the withholding tax under the double tax treaty applicable between Switzerland and the state of residence.

Transfer stamp duty

Secondary market transactions in shares of a Swiss investment vehicle are subject to transfer stamp duty if a Swiss securities dealer is involved in the transaction either

as a party or an intermediary. The applicable rate is 0.075% for each party in the trade if the party is not an exempt investor.

Issuance and redemption of shares in a Swiss investment vehicle is not subject to Swiss transfer stamp duty.

Furthermore, collective investment schemes qualify as exempt investors for Swiss transfer stamp duty, meaning that no stamp duty applies to them on the funds' own transactions.

Taxation of the investor

Swiss individual investors holding shares in a collective investment scheme as private assets are not subject to income tax on capital gains realised on the sale or redemption of their shares in the scheme, if the investor is not considered a professional securities dealer. The taxation of proceeds generated by collective investment schemes at the level of the investor depends on whether the vehicle is a distributing fund or an accumulating fund and on whether the proceeds correspond to capital gains or income generated by the fund.

Distributing investment vehicles are considered as such if they distribute at least 70% of the generated income, such as interest and dividends. Distributions are taxed at the level of the private investor. The non-distributed income benefits from a tax deferral. Furthermore, if a distributing collective investment scheme decides not to distribute any income, it will not be re-qualified as an accumulating investment scheme, if (1) 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 (2) the net income of the business year as well as income carried forward per share amounts to less than Sfr1, \$1, 1 or ¥1. However, the undistributed income must be booked in the accounts of the fund as income carried forward. Hence, the income carried forward will only be subject to tax at the time of distribution. Distributions of capital gains are not subject to income tax for private investors if capital gains generated by the fund are distributed with a separate coupon.

Income generated by **accumulating investment vehicles** is subject to tax at the level of the investor, whereas capital gains are not subject to tax if the statutory accounts allow the tax administration to distinguish between capital gains and taxable income generated by the fund.

If shares in a collective investment scheme are redeemed due to the liquidation of the investment vehicle, the liquidation proceeds less the shares' original issuance price, the investors share in capital gains



Roger Dall'O
Tax Partner AG – Taxand, Zurich

Tel: +41 44 215 77 31

E-mail: roger.dallo@taxpartner.ch

Roger Dall'O is a partner of Tax Partner AG – Taxand, the leading independent Swiss firm of tax advisers. He has more than 14 years' experience in local and international tax. His activities are mainly focused on tax planning for national and international corporations and entrepreneurs, tax advice in the area of banking and financial services and financial products. Before joining Tax Partner AG in 2004, he worked for several years at a big-four company.

and, in the case of shares in an accumulating investment vehicle, the already taxed retained income is subject to income tax.

The fair market value of the shares (NAV) in both, distributing and accumulating investment vehicles are subject to wealth tax for Swiss resident individual investors.

Swiss corporate investors or Swiss individual investors holding their shares as part of their business assets are subject to profit respectively income taxes on both the ordinary income and the capital gains generated by the investment vehicle. Proceeds generated by accumulating investment vehicles are generally recorded in the accounts of the corporate investor at the time the proceeds are distributed. However, due to a recently introduced rule in the circular letter of the Federal Tax Administration, income generated by an accumulating investment vehicle must be recognised in the accounts to enable the corporate investor to recover Swiss withholding tax.

Taxation of collective investment schemes and investors with direct possession of real estate

Collective investment schemes with direct possession of real estate are subject to tax in Switzerland on income deriving from the real estate. For profits not related to real estate (for example, interest on bank accounts) the collective investment scheme is not subject to tax.

Given that real estate income is taxed at the level of the collective investment scheme, there is no taxation of real estate income at the level of the investor. Furthermore, no withholding tax is charged on the distribution of income from direct property holdings. However, income not deriving from real estate will be subject to tax at the level of the investor and is subject to withholding tax.

If the investors in a collective investment

scheme with direct property ownership are exclusively tax-exempt occupational pension institutions or tax-exempt domestic social security institutions, the collective investment scheme is also tax exempt.

Taxation of foreign investment vehicles

The tax treatment of a non-Swiss collective investment vehicle depends on the qualification of the investment vehicle for Swiss tax purposes. The tax treatment is equal to Swiss collective investment schemes if the non-Swiss collective investment scheme fulfils one of these conditions:

- The foreign investment scheme is granted a license from FINMA; or
- The foreign investment scheme is under supervision of a recognised non-Swiss regulator; or
- The foreign investment scheme is an open investment scheme on a contractual or corporate basis with the purpose to offer collective investments and the investors have a right to redeem at net asset value at least once a year; or
- The foreign investment vehicle is a closed end investment scheme on a contractual or corporate basis with the purpose to offer collective investments.

The tax treatment for Swiss resident taxpayers is similar to an investment into a Swiss collective investment scheme and, in general, the accrued and distributed earnings are taxable at the level of the investor, whereas capital gains generated by the fund are tax exempt.

Unlike the shares in a Swiss collective investment vehicle, not only secondary market transactions, but also the issuance of shares in a foreign collective investment vehicle are subject to Swiss transfer stamp duty, if a Swiss securities dealer is involved as a party to the transaction or as an intermediary. The tax rate amounts to 0.15% for each party in the trade. The redemption of

foreign fund shares is not subject to transfer stamp duty.

A foreign investment vehicle qualifies as an exempt investor for stamp duty purposes if it is treated as a collective investment vehicle according to the conditions set out above.

Taxation of fund of funds

Fund of funds typically invest in numerous target funds. Due to the fiscal transparency of collective investment vehicles the income generated by the target funds is allocated to the master fund and taxed respectively at the level of the investors. According to the federal tax authorities' rules set out in circular letter No 24 for Swiss fund of funds, fiscal transparency needs to be applied on all levels of the fund of fund structure. Due to this rule any distributed or accumulated income of the target funds is allocated to the master fund level. Expenses of the master and target funds such as interest and manufactured dividends paid are deductible from the income. Management fees and other administrative costs are deductible from the income up to a maximum of 1.5% of the NAV. The net income accumulated at the level of the master fund constitutes taxable income. The Swiss resident investor will be subject to income tax on his share of the net income of the master fund (including the allocated net-income of the target funds). The net income of a Swiss fund of fund will in principle also be subject to withholding tax.

However, in the case of a Swiss fund of fund the master fund can book the income from a target fund as capital gain (thus, tax free for the investor) if the net income of the target fund is not more than 2% of the net asset value and the target fund is capital gains-orientated (CG-Fund). Target funds fulfilling the 2% net asset value threshold keep their qualification for a period of five years.

For non-Swiss fund of funds this 2% rule does not apply and any taxable net income of a target fund needs to be allocated to the master fund. However, for a foreign master fund fiscal transparency is only applied on the first level of the fund of fund structure if the master fund is invested in at least five target funds.

Taxation of carried interest

The main issue about the taxation of fund managers is this: If a capital gain is realised on privately held assets, the capital gain is tax free. On the other hand a capital gain on business assets is considered taxable income from self-employment (subject to income tax and social security). Hedge fund



Monika Gammeter Utzinger
Tax Partner AG – Taxand, Zurich

Tel: +41 44 215 77 29

E-mail: monika.gammeter@taxpartner.ch

Monika Gammeter Utzinger is a senior manager of Tax Partner AG – Taxand, the leading independent Swiss firm of tax advisers. She has more than 15 years' experience in local and international tax law. Her activities are mainly focused on tax planning for national and international corporations and entrepreneurs, restructuring of national and international corporations and tax advice in the area of banking, financial services and financial products. Before joining Tax Partner AG – Taxand in 2003, she worked for several years for the cantonal tax authorities in Zurich.

and private equity managers usually need to invest their own money in the investment vehicle to show their commitment to the other investors. In this context the question is, whether the shares held by the fund managers are private assets or business assets. The basic principle provided by a draft circular letter of the federal tax authorities is that capital gains, carried interest and performance fees that are more than the proportional return on investment, compared to third-party investors in the fund, are considered as fully taxable income whereas capital gains in proportion to the investment made by the managers are, in principle, tax exempt.

According to the draft circular letter three basic structures are generally approved by the Swiss tax authorities.

With the so called **loan model** assets are contributed to the fund by the other investors (lenders) through debt or hybrid instruments. At maturity of the fund the debt is first paid back to the lenders and the remaining profits are split between the fund managers and the other investors to achieve a proportionate return on investment.

Another possibility is the **two step model**. The fund managers will invest directly in nominal capital as any other third-party investor would. A company controlled by the fund managers subscribes to a special share class of the fund which is entitled to the performance fee or carried interest. The fund managers are either shareholders or are employed by the company – or both – and receive dividends and/or salary from the company. If ordinarily taxed, the effective tax burden of the company typically ranges between about 11% to 25% depending on the domicile. For cantonal tax purposes it can be evaluated whether the Swiss company qualifies for a privileged cantonal taxation scheme. Under a privileged cantonal tax regime the tax rates range

between about 9% to 12%. Swiss resident managers will have to pay tax on employment income at ordinary rates. The overall tax burden depends on the canton/community of residence of the fund managers and ranges between about 20% to 45%. Due to a recently introduced tax reform the fund managers may benefit from a special relief on dividends received from the company. If the payment to the managers is made in as a dividend this results in a higher profit for the company, but on the other hand, depending on the residence of the managers, the dividend will be subject to a special dividend relief.

Another solution is the use of offshore structures (**Foreign Fund structure**), when setting up a hedge or private equity fund. The fund and its principal structures are in this case located abroad, but certain functions are delegated to persons or entities in Switzerland. The Swiss tax authorities will in this case carry out a function and risk analysis of the activities performed in Switzerland and offshore, and an international allocation for the management fees and the performance fees needs to be made. The purpose of this structure is to reduce the worldwide taxation of the implicated Swiss fund managers.

More to be done

Due to its favourable tax rate regime and an excellent ruling practice, sound infrastructure and large investor base, Switzerland will continue to attract business in the fields of fund distribution and fund management. However, due to the withholding tax trap Switzerland can mainly be promoted as a set-up location for private equity and hedge funds. From a tax point of view further measures, in particular a relaxation with regard to Swiss withholding tax is necessary to strengthen Switzerland's position as a leading centre for investment funds.



“Safe landings require
the right equipment. We have it.”

The bailout record is held by Joseph Kittinger. On 16 August 1960, he jumped from an altitude of 31,332 metres in New Mexico (USA). Evgeny Andreyev takes credit for the longest free fall in history with 28,457 metres on 1 November 1962 over the Russian city of Volok. Don Kallner's record of parachute jumps remains unbroken. He started his skydiving career with the first of over 38,000 jumps in June 1961.

We compete with the best.

Tax Partner AG
Consultants

Telstrasse 80
8001 Zurich
Switzerland

Phone +41 44 215 77 77
www.taxpartner.ch


Taxpartner
Tax and

www.taxand.com

