Taxation of structured products in the Swiss retail market

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This article mainly deals with the products of the Swiss Listed Derivative Map: derivatives *(Hebel-Produkte)*, capital-protected products *(Kapitalschutz-Produkte)*, reverse convertibles *(Renditeoptimierungs-Produkte)* and certificates *(Partizipations-Produkte)*. From a Swiss tax point of view, structured products are a composition of interest-bearing loans and options. According to Swiss administrative practice, capital-protected products and reverse convertibles are structured products (with a bond as host contract), even though these products may also be structured through an options strategy only (call/put parity). This practice raises doubts of constitutional legality.

Furthermore, this article deals with two investors in the Swiss retail market. The first is an individual who is resident in Switzerland and holds the structured product as a private asset *(Privatvermögen)*. The second is an individual who is resident in an EU member state and receives an interest payment through a Swiss paying agent. The first investor is subject to Swiss income taxation, the second is subject to the EU savings tax retention.

Income and withholding taxes

At the level of private individuals, investment income is taxable where capital gains are tax-free. Interest from Swiss debentures *(Obligationen)* are subject to withholding tax at a rate of 35%. Because of this dualism between taxable investment income and tax-free capital gain, a structured product is separated out into its component parts for Swiss income and withholding tax purposes. The magic word is "bifurcation". Because of the withholding tax, structured products (with a bond as host contract) are generally not issued by Swiss entities.

Stamp duty

The issuance of Swiss debentures *(Obligationen)* is subject to stamp duty. Swiss bonds *(Anleihensobligationen)* are taxable at a rate of 0.12% for each full or partial year of the maximum term. Swiss money-market papers *(Geldmarktpapiere)* with a term not exceeding one year are subject to 0.06% pro-rated at 1/360 of the tax rate for each day. The stamp duty is another reason why structured products (with a bond as host contract) are generally not issued by Swiss entities.

Irrespective of whether they are issued by Swiss or non-Swiss entities, structured products (with a bond as host contract) are subject to turnover stamp duty if a Swiss securities dealer is involved either as party or intermediary: Swiss securities at a rate of 0.15%, non-Swiss securities at a rate of 0.3%. This direct discrimination of non-Swiss securities also raises doubts of constitutional legality. Money-market papers are exempt.

EU savings tax retention

On behalf of the EU member states, Switzerland levies the EU savings tax retention on interest income paid by a Swiss paying agent to a beneficiary who is an individual resident in an EU member state. Since 1 July 2008, the rate is 20%. Interest paid by Swiss entities (Swiss debentures, Swiss bank deposits) are out of scope.

Structured products (with a bond as host contract) sold in the Swiss retail market are in general in scope of EU savings tax retention, because they are generally issued by non-Swiss entities. In respect of capital-protected products, the difference between the capital protection and the issuance amount as well as periodic interest payments are in scope. Periodic interest payments from reverse convertible are in scope too. However, certificates are out of scope.

Bonds

The federal parliament enacted a statutory anti-avoidance provision for income-tax purposes (but not for withholding-tax purposes) applicable to private investors. If a bond or money-market paper with a predominant one-time interest payment (so-called IUP = *intérêt unique prédominant)*, such as a zerobond, is sold prior to redemption, the accrued interest is taxable upon redemption *(reine Differenzbesteuerung)*. Periodic interest is taxed on the payment date. In contrast, the sale of non-IUP bonds does not trigger income taxation. The discount is taxable only upon redemption. The private investor may escape final taxation through a sale prior to redemption.

Derivatives

Options, futures and swaps are treated as tax-free derivatives. Premiums and capital gains are income-tax-free and not subject to withholding tax. Derivatives are neither subject to issuance nor to turnover stamp duty, if they are issued by a Swiss entity.

Structured products

Structured products are separated out into the host contract and the embedded derivatives. Premiums and capital gains derived from options are income-tax-free. In contrast, interest income derived from the bond is subject to income taxation. The accrued discount of IUP bonds is subject to taxation upon sale *(modifizierte Differenzbesteuerung)*. The present value of the bond at issuance is determined by virtue of the applicable swap rate *(analytische Methode)*. The present value on sale is determined by virtue of the applicable 5-year swap rate. Capital gains and losses from differences in interest and exchange rates increase or decrease taxable interest income. The discount of non-IUP bonds is only taxable upon redemption.

Capital-protected products

The general rules for structured products are applied to capital-protected products which are basically compositions of bonds and long call options. The overall protected amount of the composed product is treated as nominal value of the bond. If the majority of the return of the bond is in the form of a discount, the increase of the value of the bond is subject to income taxation upon sale prior to redemption *(modifizierte Differenzbesteuerung)*. The investor who buys the product at issuance and holds it until maturity is taxed on the difference between the present value of the bond at issuance and its present value at redemption. Periodic interest payments are subject to income taxation on payment date. Any gain derived from the option is tax-free capital gain. The product is not in scope of the EU savings tax retention, if the capital protection does not exceed the issuance amount and the product does not pay periodic interest.

Reverse convertibles

Discount certificates are treated as tax-free derivatives if they have a term not exceeding one year and do not pay periodic interest. The discount is income-tax-free, and the issuance is not subject to issuance stamp duty, even if the product is issued by a Swiss entity. The product is also not subject to EU savings tax retention.

The general rules for structured products are also applied to reverse convertibles, which are basically compositions of bonds and short put options. The repayment amount which the investors receive if the delivery of the underlying is not triggered, is treated as nominal value of the bond. The coupon is split into a tax-free premium and a taxable interest amount. The interest coupon is taxed on payment date. If the bond qualifies as non-IUP bond, the discount is taxed upon redemption. The cash settlement does not trigger turnover stamp duty. However, the physical delivery of taxable securities triggers stamp duty. The periodic interest coupon is subject to EU savings tax retention.

Certificates

Certificates on indexes and baskets on shares are either treated as tax-free derivatives or taxable units in collective investment schemes.

If it is a static index or a basket on shares, the certificate is treated as a tax-free derivative. Therefore, capital gains derived from the sale of the certificate are income-tax-free. However, dividend compensations (e.g. in the form of a discount) are taxable investment income. Such certificates are not subject to withholding tax nor issuance nor turnover stamp duty, even if they are issued by a Swiss entity.

Certificates on dynamic indexes or baskets of shares which are actively managed are treated as units in a collective investment scheme *(anlagefondsähnliches Vermögen)*. Therefore, a similar income-tax treatment is applied as for collective investment schemes. Furthermore, certificates on baskets of collective investment schemes are treated similarly to units in collective investment schemes. If those certificates are issued by a Swiss issuer, they are neither subject to withholding tax nor to turnover stamp duty. This direct discrimination of non-Swiss certificates again raises doubts of constitutional legality.

Certificates on baskets of bonds are treated similarly to units in collective investment schemes which invest in bonds.

Funds of funds

The increased variety of certificates on dynamic indexes or baskets of shares has raised difficulties to draw the line between structured products and regulated collective investment schemes. A similar complexity arises in respect of funds of funds, if the overlying fund of funds is treated fiscally transparent according to Swiss tax rules (e.g. Sicav-like vehicles). Funds of funds may also be structured as underlyings of call options which are, in turn, embedded derivatives of capital-protected products.

For Swiss income tax purposes, actively managed funds of funds are divided into capital-gains funds and income funds. If the investment policy of the subfunds is aimed at capital gains (e.g. hedge funds), the subfunds are qualified as capital-gains funds (type "KG"). The subfunds are fiscally non-transparent, regardless of their legal (corporate or contractual) structure. The private investor (through the transparent fund of funds) is not taxed on a current basis in respect of investment income realized at the subfund level. The investment is income-tax-free.

However, subfunds are qualified as income funds (type "KE") if their investment policy is aimed at investment income (e.g. money-market funds or bond funds). In this case, the subfunds are fiscally transparent regardless of their legal (corporate or contractual) structure. This disregard once more raises doubts of constitutional legality. The private investor (through transparent funds of funds and subfunds) is taxed on a current basis in respect of investment income (interest, dividend) at the subfund level. Therefore, similar to certificates on a dynamic index or basket of shares, a similar income-tax treatment is applied as for collective investment schemes. To avoid adverse discretionary tax assessment at the level of the individual investors, the issuer of the certificates of a fund of funds should provide adequate investment reporting at the level of the subfunds.

Summary

Discount certificates, certificates on static indexes and baskets of shares, as well as certificates on capital-gains funds are most tax-attractive for Swiss private retail investors.

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