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Taxation of Hedge Fund Managers in Switzerland

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Thierry Boitelle

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Taxation of Hedge Fund Managers in Switzerland :

1. The Swiss ambition, what's at stake and missed opportunities
2. Practice of the Swiss tax authorities
3. Optimization for Swiss resident hedge fund managers
4. Tax planning (income and wealth)
5. Effective management of hedge funds and of other off-shore entities : how to limit the tax risks ?
6. Some regulatory aspects (FINMA)

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THE SWISS AMBITION

- Swiss government and Swiss financial industry have expressed the ambition to become a more important global financial center, specifically in the field of hedge funds and private equity (e.g. Financial Centre Dialogue Steering Committee)
- Swiss financial industry in need of diversification in the information exchange era (« the aftermath of bank secrecy »)
- Developments abroad creating huge opportunities : e.g. increasing tax charges in competing financial centers such as the UK and the US, growing regulatory pressure in the EU and the US and the global trend to locate fund structures « on-shore »

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WHAT'S AT STAKE

- **There is a real opportunity to become an important global financial center without the need for bank secrecy**
- **The need to develop new activities for the Swiss financial industry is also a reality**
- **It's crucial that solutions be found to guarantee access to EU/EEA markets for Swiss funds and Swiss fund managers (UCITS IV, AIFM etc.)**
- **Action is needed to face increased competition, particularly from EU Member States (e.g. in the field of funds : Luxembourg and more recently Malta)**
- **Thousands of high-quality jobs are concerned**
- **Important growth potential for the Swiss GDP (hedge funds already account for 1% of the Swiss GDP according to the SFA) and significant tax revenues can be expected**

MISSED OPPORTUNITIES

- **Inadequate and too restrictive promotion of private equity (e.g. the Socari applies only in a Swiss domestic context)**

- **Draft circular letter concerning carried interest and performance fees is rather restrictive and not sufficiently attractive**

- **Absence of attractive Swiss investment funds (withholding tax trap) :**

  - 80% of "Swiss" funds are exported to Luxembourg

  - thousands of jobs created abroad and Switzerland is missing out

  (see next slide)

Export of Swiss jobs to finance center Luxembourg !

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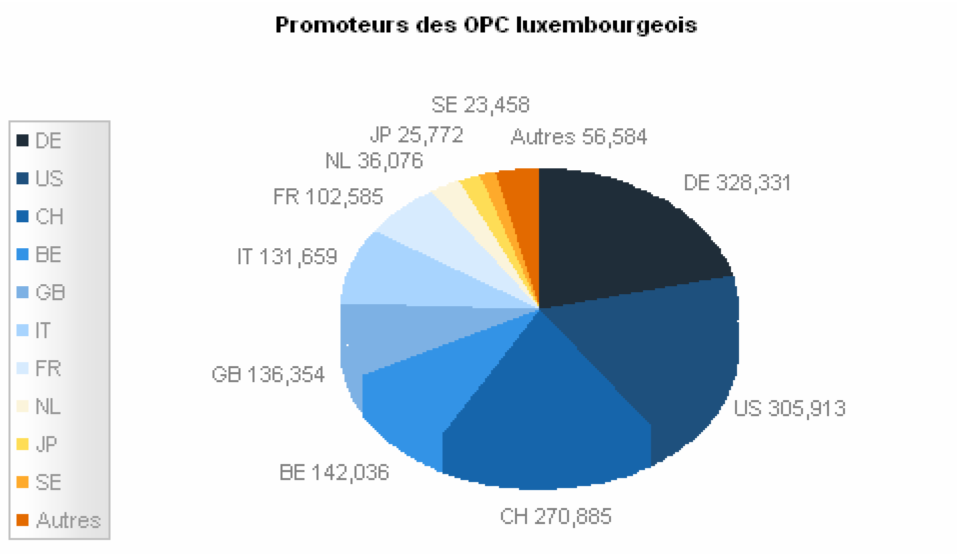
Origin of Luxembourg fund promoters :



Pays d'origine	Actifs nets (en mia EUR)	en %
Allemagne (DE)	328,331	21,1
Etats-Unis (US)	305,913	19,6
Suisse (CH)	270,885	17,4
Belgique (BE)	142,036	9,1
Royaume-Uni (GB)	136,354	8,7
Italie (IT)	131,659	8,4
France (FR)	102,585	6,6
Pays-Bas (NL)	36,076	2,3
Japon (JP)	25,772	1,7
Suède (SE)	23,458	1,5
Autres	56,584	3,6
TOTAL	1.559,653	100

Because of its restrictive tax and regulatory policies, Switzerland has contributed substantially to the development of Luxembourg as a finance center with over 70’000 jobs in the financial industry in 2007 (Statistics of the Commission de Surveillance du Secteur Financier, Luxembourg, October 2008)

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Source: Commission de Surveillance du Secteur Financier, Luxembourg (www.cssf.lu)

2. Practice of the Swiss tax authorities

Draft circular letter (of September 2008) regarding the tax treatment of remuneration of hedge fund and private equity fund managers (not yet published and in German only).

Basic principles (valid for direct federal tax only) :

1) All implicated Swiss persons and entities should declare income, management fees, salaries and bonuses that meet the at arm's length standard (fair market) and such income is taxed ordinarily.

2) Capital gains in proportion with the investment made by the manager are in principle tax exempt. Participations of the manager in other entities of the fund structure are generally treated as private assets. For possible other assets and investments of the manager, the qualification « private or commercial asset » remains open.

3) Capital gains, carried interest and performance fees etc. exceeding the normal return on investment (as compared with third party investors) are considered fully taxable income.

2. Practice of the Swiss tax authorities

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Draft circular letter (cont'd) – three structures explicitly approved :

Structure 1 – Fund with debt financing and/or a special share class

Structure 2 – Investment by the managers in two steps

Structure 3 – Foreign fund structures

These structures (or aspects thereof) can be combined.

However, often not appropriate in a new immigration case, since existing structures are already in place and cannot be (drastically) changed.

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Structure 1 – Fund with debt or special share class

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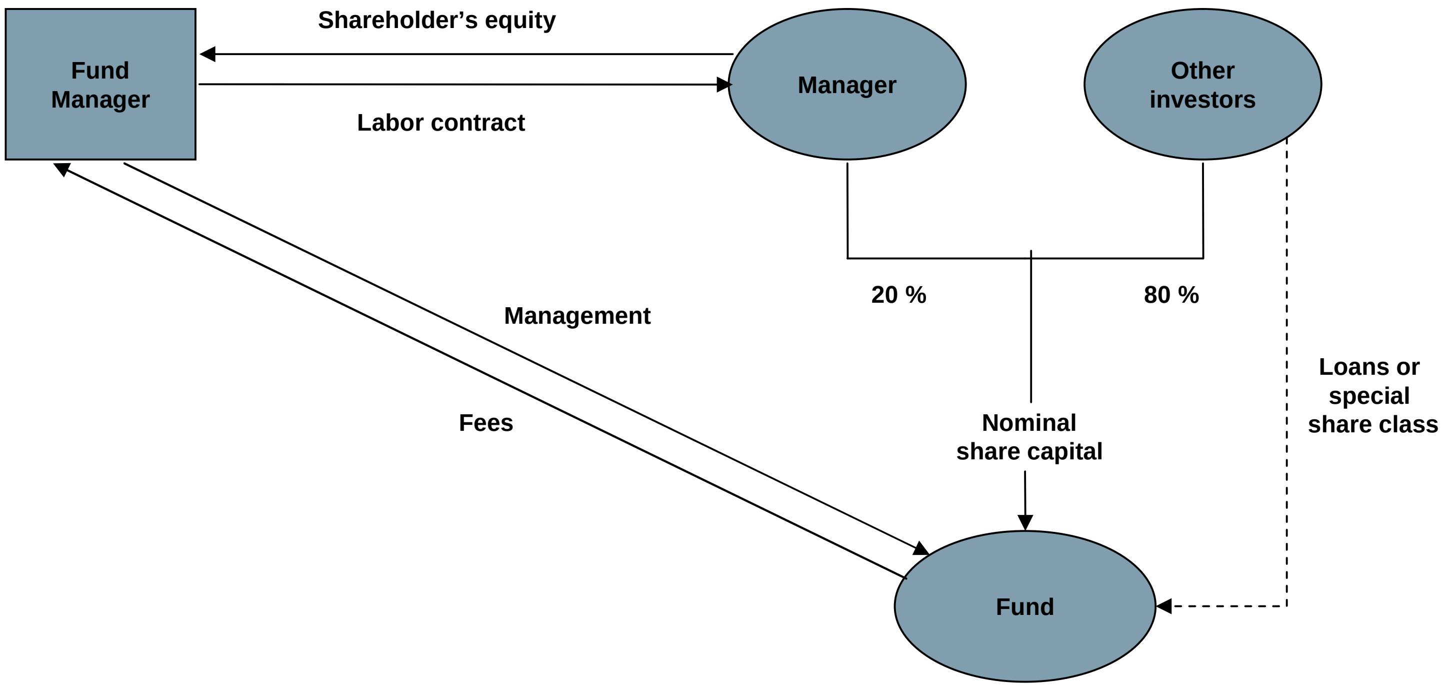

- The managers invest 20% of nominal share capital and the investors 80%
- The vast majority of investment is made in the form of loans or a special share class
- Profits are firstly distributed to the holders of the nominal share
  → purpose: to earn carried interest or performance fees as a tax exempt capital gain with a participation in the nominal capital of 20% without prohibitive up-front costs / investments.

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Structure 2 – Managers invest in two steps

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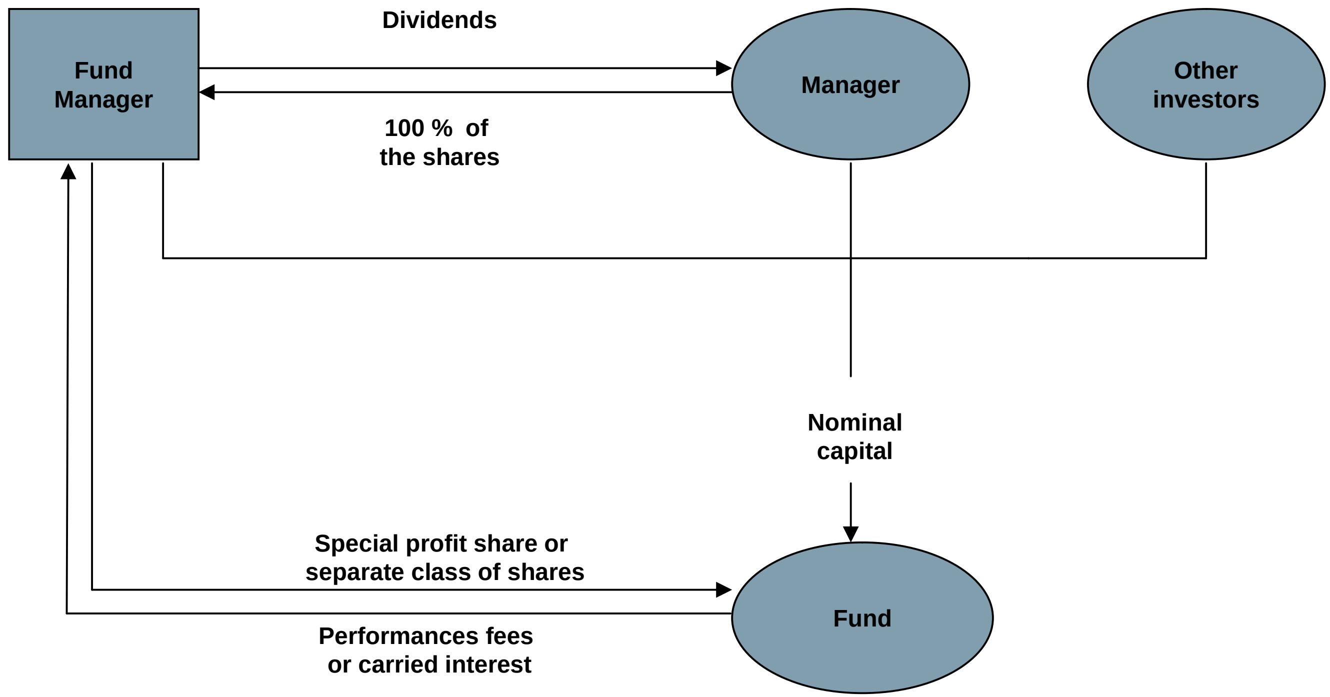

- The managers invest in the nominal capital as any other (third party) investor
- A company controlled by the managers (e.g. the Fund Manager) subscribes to a special share class which is entitled to the performance fees or carried interest

  → purpose: to realize (a) a tax-free capital gain and (b) to earn carried interest or performance fees under privileged taxation (combination of foreign low taxed Fund Manager with privileged taxation of dividends for substantial shareholders)

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Structure 3 – Foreign fund structures

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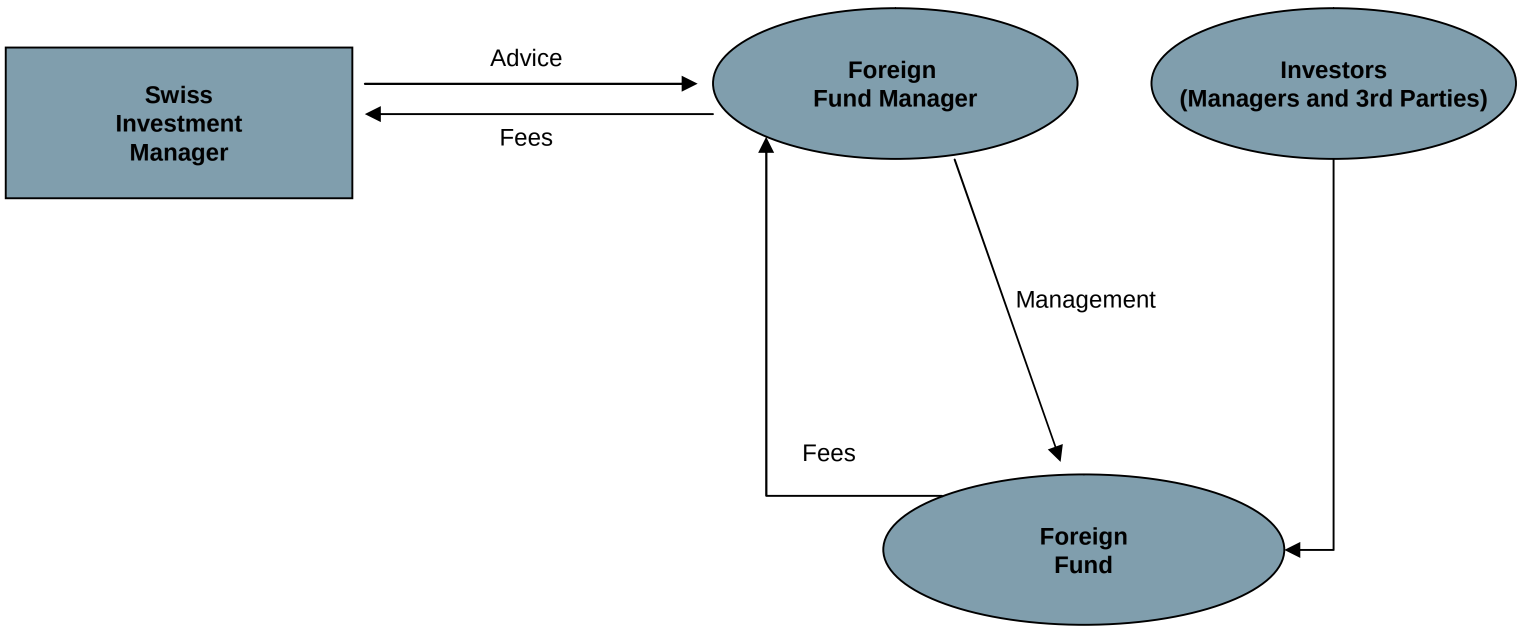

- **The fund and its principle structures are abroad, perhaps in a tax haven**
- **Certain tasks are delegated to persons or entities in Switzerland**
- **An international allocation must be made for the management fees and the performance fees or carried interest**

  → purpose: to reduce the world-wide taxation of the implicated Swiss residents

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Other optimization structures – basic principles :

- **International allocation (e.g. with tax haven structures)**
  - allocation based on economic analysis (transfer pricing report) of the different functions and risks (who does what where)
  - golden triangle of transfer pricing : allocation of assets, functions and risks
  - simple administrative activities : cost-plus method approved
  - of other activities in principle no cost-plus but rather allocation of fees

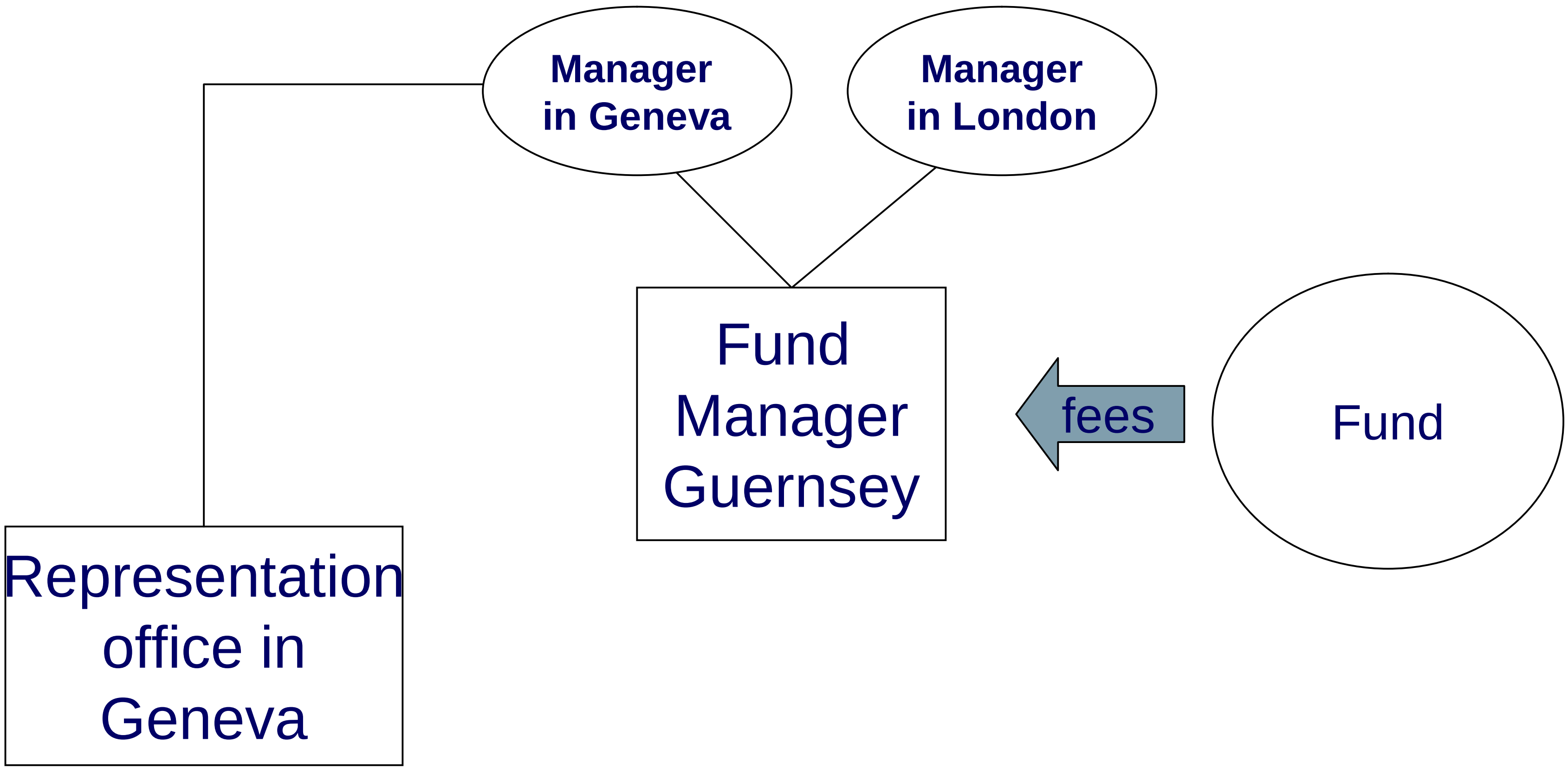
- **General exemption for profits generated through foreign branches or subsidiaries (even if located in a tax haven)**

- **Private capital gains are exempt**

- **Partial taxation of dividend income for substantial shareholders**

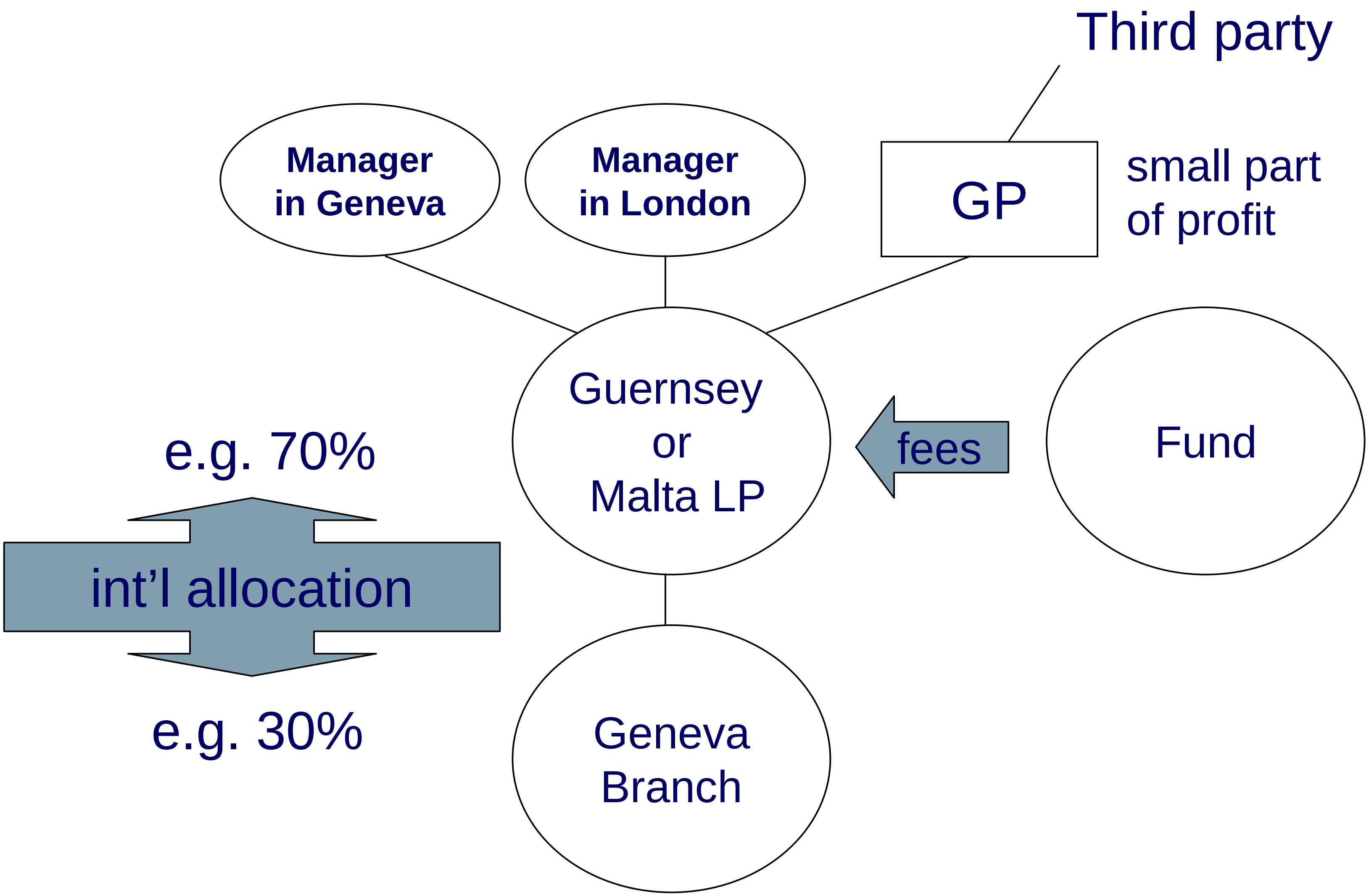
- **In all cases rulings are necessary – the authorities are willing to discuss as long as all implicated Swiss residents declare a fair market salary and bonus (taxed ordinarily)**

3. Optimization structure with representation office



Cost-plus ?

3. Optimization structure with Guernsey or Malta LP



3. Example of an international allocation schedule

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A draft analysis of the distribution of activities for the XYZ Fund:

Activity		Geneva %	London %	Elsewhere %
Fund Management	Investment decisions	5	75	20
	Company monitoring	-	20	80
	Legal arrangement (for each investment)	-	6	94
Administration	General Administration	70	30	-
	Financial Administration	90	10	-
	Human Resources	90	10	-
	Marketing / Publicity	90	10	-
	IRP / selection	40	20	40

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3. Optimization structure with Guernsey and Malta

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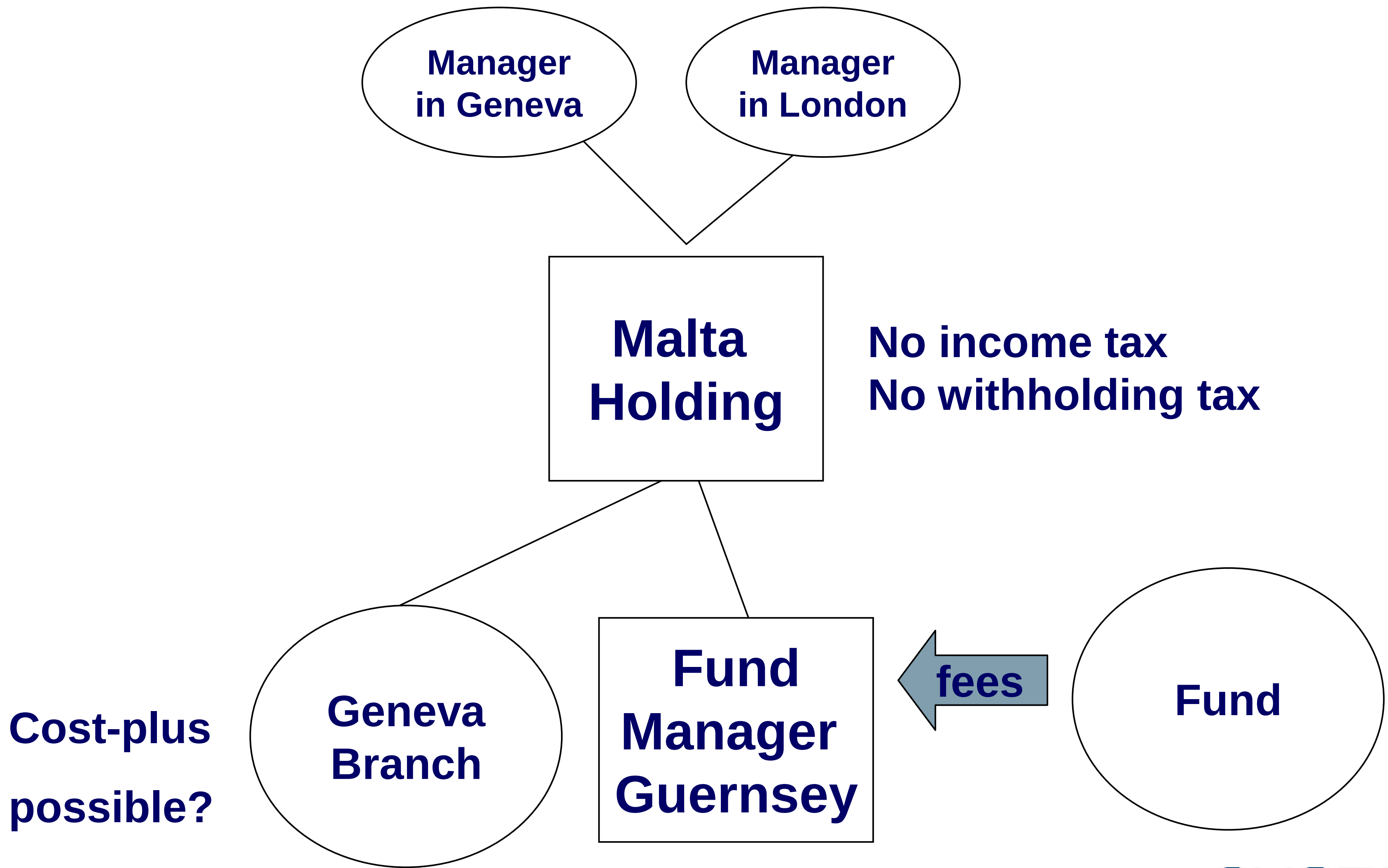

4. Tax planning (income and wealth)

Switzerland offers other interesting tax planning tools, such as :

- **Recognition of Trusts (irrevocable and discretionary) - potentially of use when contributing assets to a Trust before taking residence in Switzerland. Use of « Employee Benefit Trusts (EBTs) » to defer taxation on part of the income, etc.**
- **Lump sum taxation (« forfaits ») – possibly interesting for those who take residence in Switzerland without having a lucrative activity in the country (activity abroad allowed)**
- **New : tax cap (« bouclier fiscal ») e.g. in Geneva and Vaud, see next slide**
- **Classic Swiss tax planning instruments :**

  - Contributions to LPP pension fund, buyback of missing years of contribution (generally limited during the first 5 years after immigration) ;
  - Real estate investment (deduction of interest, costs, maintenance etc.) ;
  - Flat representation allowances (e.g. in Geneva 5 to 10% of salary and bonus) ;
  - Particular tax benefits for expatriates

4. Tax planning (income and wealth)

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The tax cap : Vaud (2009), Geneva (2011), but also in Valais and Berne (the « Bertarelli » case)

Principle : combined municipal and cantonal taxation on income and net wealth may not exceed 60% of the net taxable income
On top of that: 11.5% federal direct tax !
Maximum tax charge 71.5%, but some anti-abuse rules apply :
- minimum taxable return on private assets = 1% of the net wealth
- minimum taxable return on commercial assets = 3.5% for the year 2008 (according to the Swiss Federal Pension Plan rate of return on equity deployed in a closely held business)

The tax cap thus favors high net wealth with relatively low income

→It can be a tool for tax planning for high net wealth individuals provided the taxable income can be kept at a minimum

→Potentially interesting for managers of private equity and hedge funds

→Possible alternative for the lump-sum taxation ("forfaits")

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Effective management and tax risks :

If a foreign entity is effectively managed from Switzerland, such entity (e.g. the Fund or the Fund Manager) will be considered a Swiss entity and taxed accordingly

This implies a/o : generally 15 to 25% income tax, 35% withholding tax on (deemed) distributions, 1% capital contribution tax and 1,5 per mille transfer tax on any transfer of title with the implication of a Swiss securities dealer

How to limit the tax risks ?

Ensure day-to-day management abroad, dispose of sufficient substance abroad (e.g. qualified personnel, adequate office space, etc.), board meetings always held abroad, preferably no Swiss residents on the board, administration, bookkeeping and bank accounts kept abroad, etc.

5. Effective management of hedge funds / off-shore entities

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Important relaxation : new SFTA Circular Letter no. 24 of January 1st, 2009

Services such as investment management, fund administration and product management can be rendered from Switzerland, if and insofar the following two cumulative conditions are fulfilled :

1) The board of the fund must (i) at least supervise the commercial activity and ensure that the relevant legal regulations are respected and (ii) must be composed in majority of non-Swiss residents and must (iii) always meet outside of Switzerland ;

2) The depositary bank does not have its seat in Switzerland (although a foreign branch of a Swiss bank is OK). Delegation of technical tasks of the depositary bank to Switzerland is authorized.

- **The circular is still recent, there are no further technical explanations, no jurisprudence or relevant literature, etc. (but at the same time the intention is clear and it has become practice of the Swiss financial industry)**
- **Highly recommended to request advance tax rulings on these matters**

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6. Some regulatory aspects (FINMA)

- **Principle : collective investment schemes are subject to FINMA supervision.**
- **Exception : foreign funds that do not approach the general public, in or from Switzerland**
- **FINMA refers to the place of effective management and not to the legal seat in order to determine if a fund is based abroad or in Switzerland, in which latter case the fund would be subject to supervision.**
- **As a consequence, a fund that is effectively managed from Switzerland, can be subject to the Collective Investment Scheme Act (CISA) and as such to supervision by FINMA even if its statutory seat is abroad.**
- **Based on the criteria in the ordinance to the CISA, the main management of a fund is in Switzerland if :**
  - ***a. The non-transferable and indefeasible duties of the board of directors pursuant to section 716a of the Swiss Code of Obligations are performed in Switzerland.***

6. Some regulatory aspects (FINMA)

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b. For each of the funds managed by the fund management company, at least the following duties are performed in Switzerland:

1. decision on the issuance of units,

2. decision on the investment policy and asset valuation,

3. asset valuation,

4. fixing of the issuance and redemption prices,

5. determination of the distribution of profits,

6. determination of the contents of the prospectus, simplified prospectus, annual respectively semi-annual report as well as of further investors' publications,

7. accounting.

- **The effective management of a fund is located abroad according to FINMA if <u>none</u> of the above mentioned criteria are met.**
- **If certain of these activities are exercised from Switzerland, FINMA could take the position that the fund is effectively managed from Switzerland and should thus be subject to its supervision according to CISA.**

6. Some regulatory aspects (FINMA)

- **In order to avoid being subject to FINMA supervision, a foreign fund must ensure that no publicity for the general public is made in or from Switzerland and thus to distribute the fund exclusively to qualified investors.**

- **FINMA is willing to issue advance agreements (*rulings*) on this issue, upon written request and presentation of the detailed facts and notably a description of all activities undertaken from Switzerland.**

- **As a general rule and in practice, a Swiss fund manager will typically obtain a "light" license from FINMA, not so much to satisfy Swiss regulation, but rather to meet EU rules that require a fund manager to be subject to supervision. Once such license is obtained, the Swiss manager can take up several mandates from various funds based in the EU.**

Any questions ?

Thierry Boitelle

boitelle@altenburger.ch

ALTENBURGER LTD legal + tax

Zurich
Seestrasse 39
CH - 8700 Küsnacht
Tel. +41 44 914 88 88
zurich@altenburger.ch
www.altenburger.ch

Geneva
Rue Rodolphe-Toepffer 11bis
CH - 1206 Geneva
Tel. +41 22 789 50 20
geneva@altenburger.ch
www.altenburger.ch