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Project - Flate Rate Tax

Flat rate tax on assets held with banks on a cross-border basis

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Executive Summary

The flat rate tax project proposal is jointly sponsored by the Swiss banks. The aim is to ensure that the assets deposited by foreign-domiciled clients with Swiss banks are compliant with the income tax laws of their relevant tax domicile. At the same time the purpose is to protect the privacy of these clients.

Switzerland offers to collect the flat rate tax on income paid on balances of foreign-domiciled clients for countries that wish to avail themselves of the service. This tax is deducted by the paying agent (the bank) and credited to the tax authorities of the client's tax domicile.

In return, Switzerland demands undiscriminated access to the financial markets of these countries under prevailing national law.

1. Background and objectives

1.1. Flat rate taxes in the international context

Various countries – including 19 EU member states – operate a system of flat rate or withholding tax for the taxation of capital income of natural persons. Interest, dividends and, in some cases, capital gains on securities are taxed by so-called paying agents. They assess and withhold the tax due on the interest, dividends and capital gains for the client at a proportional rate and transfer the tax payable directly to the tax authorities.

The flat tax or withholding tax system under domestic law is gaining traction. It is used in Germany, Italy and Spain, for instance. All twelve new EU member states introduced a flat rate or withholding tax model on joining the EU. A similar withholding tax concept is also being applied under the bilateral agreements between the EU and Switzerland on interest taxation (see the study by Dr. Svaljek commissioned by the European Policy Forum, enclosure 1).

Switzerland has had considerable experience with its federal withholding tax, which is modelled on the taxation at source principle. The implementation by Switzerland of the EU Savings Tax Agreement was generally well received by all those involved.

Italy uses a "tax agent" model (*sostituto d'imposta*) to levy its flat rate tax on income and capital gains. The tax agent collects the tax due directly from the employer (wages) or from the banks (investment income) and delivers it anonymously to the state. This then constitutes final and definitive payment of tax. The tax subject concerned does not need to complete any further tax returns. Where investment income is concerned the banks may themselves apply to perform the services of the tax agent, which deducts and transfers the tax due.

In the case of the flat rate tax on investment income introduced in Germany on 1 January 2009 the bank as paying agent deducts the tax on the investment income (capital gains, interest and dividends) at source and transfers it to the relevant tax authority without naming the tax subject involved.

1.2. Conceptual idea

The role of wealth management banks has traditionally been to ensure professional management of the assets entrusted to them. In Switzerland discretion is a fundamental principle that for historical reasons is closely linked to the wealth management profession.

In recent years the role of the wealth manager has developed further, necessitating adjustments to the rules of bank client confidentiality. An example of this is the fight against money laundering, which no bank may refuse to comply with on the grounds of bank client confidentiality.

Basically the banks are not responsible for verifying whether the assets of their clients comply with the tax rules of their respective tax domicile.

In this connection the Swiss banks are proposing the flat rate tax model, which is in line with their traditional values and with the issue of discretion in particular. The aim is to ensure that the assets deposited by foreign-domiciled clients with Swiss banks are compliant with the income tax laws of their relevant tax domicile.

The flat rate tax proposal is aligned to the Italian and German models which protect the client's privacy while at the same ensuring definitive payment of the latter's tax.

Switzerland offers to collect the flat rate tax on income paid on balances of foreign-domiciled clients for countries that wish to avail themselves of the service. This tax is deducted by the paying agent (the bank) and credited to the tax authorities of the client's tax domicile.

The flat rate tax means:

- that the client's/tax subject's obligations to the tax authorities of his/her/its country of domicile are fulfilled. It is thus no longer necessary to report the client's/tax subject's assets and investment income to the tax authorities.
- that the client's anonymity can be protected. The issue of automatic exchange of information thus becomes obsolete.

With the flat rate tax model, clients still have the possibility of electing to have their assets reported instead of paying the flat rate tax, if they so wish.

1.3. Objectives

The flat rate tax project has the following objectives:

- **Flat rate tax with a prospective effect and protection of privacy:** The taxation of the investment income is definitive. The treaty states receive the full amount of tax owed immediately and the client's financial privacy is guaranteed long-term.
- **Possible flat rate tax with retroactive effect:** If treaty states so wish, it would be possible to incorporate a flat rate tax with retroactive effect in the model. Alternatively the assets of certain clients would be decriminalised after expiry of the limitation periods.
- In return, the treaty states would guarantee Switzerland **undiscriminated access to their financial markets** on the basis of their national laws.

2. Concept of the flat rate tax

2.1. Basic principles

Switzerland concludes a bilateral treaty with EU member states under which the tax due on assets of clients domiciled in the treaty states would be registered and transferred by a paying agent domiciled in Switzerland, depending on the requirements of the applicable local tax laws. Switzerland offers a modular system for this purpose, which is a further development of the EU paying agent tax (module 1) and additionally records dividends (module 2) and collective investment schemes (module 3) plus, on top of the initial modules, capital gains (module 4) and, if required, assets (module 5).

The model envisages the collection of the flat rate tax via the paying agent. The paying agent will be the bank at which the account is maintained, as previously defined in the EU paying agent tax. The paying agents thus acquire the status of a tax agent, which levies the tax due annually on the client assets deposited with and managed by the bank in Switzerland at the rates applicable in the client's tax domicile and transfers this to the Federal Tax Administration (FTA) without disclosing the client's name but stating only his/her/its country of domicile.

The model is generally also open to parties with progressive rates of tax, but on condition that a uniform rate is applied. A progressive taxation system would be technically virtually impossible to implement.

In accordance with the requirements of the country of domicile, all investment income such as interest, dividends, income from collective investments and capital gains on all the assets held by the client would be taxed via four modules. The same applies to assets held via structures where the client is the beneficial owner

The FTA then transfers the total of the tax due to the relevant tax domicile of the client once a year. The same procedure is followed here as applies under the Savings Tax Agreement between Switzerland and the EU.

The payment of the flat rate tax by the client is definitive, meaning that the client's assets held with a bank in Switzerland have then been definitively assessed. The client

no longer needs to declare the assets concerned in his/her/its annual tax return. The client receives (on request) an annual tax statement from the paying agent showing the tax amounts deducted.

Upon expiry of the limitation periods applicable in the client's tax domicile, the client should be able regard the funds as tax-compliant and hence declared in full. The client should be able to provide proof of this by submitting the tax statements issued by the paying agent. Alternatively, a retroactively applicable flat rate tax may be incorporated into the model.

2.2. Definition of paying agents

The paying agents for the purposes of the flat rate tax model are the same as those used for payment of the EU Savings Tax. Paying agents are defined in Switzerland as banks under the Swiss Banking Act, securities traders under the Federal Act on Stock Exchanges and Securities Trading, natural persons and legal entities, partnerships and operating units of foreign companies resident or established in Switzerland that regularly or occasionally receive, hold, invest or transfer assets of third parties as part of their business activities.

2.3. Tax subjects concerned

The primary subjects concerned are natural persons resident in a treaty state. The flat rate tax model also applies to domiciliary companies such as domestic or foreign legal entities, companies, *Anstalten* (establishments), foundations, fiduciary companies or similar associations that do not engage in any commercial or manufacturing business or any other form of commercial operation the beneficial owners of which are natural persons domiciled in a treaty state.

2.4. Investment income and possibly assets affected

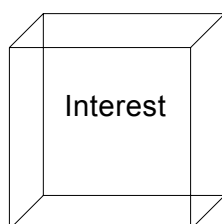
The flat rate tax model consists of the following five modules:

2.4.1. Module 1 – Interest

The provisions of the EU Savings Tax Agreement apply fully to the taxation of interest.

Nothing changes here for residents of EU member states. Module 1 is already being applied today under the provisions of the Savings Tax Agreement between Switzerland and the EU.

This will remain so in general, so that the other modules can build upon the Savings Tax Agreement. The only reservation is in the area of the applicable rate of tax. This would have to be reduced in the course of the adjustment of the EU Savings Tax Agreement from 35% (starting in 2011) to the local rate of each treaty state. The federal government's share might also need to be adjusted together with the other modules.

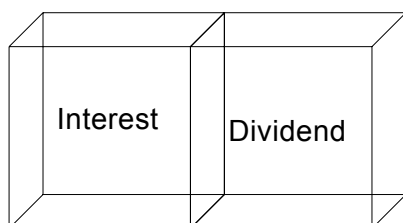


2.4.2. Module 2 – Dividends

In addition, the Savings Taxation Agreement will also be extended to include dividend payments.

The principles of module 2 are already familiar from the US Qualified Intermediary Agreement. This could be extended with a reasonable amount of effort to include stocks.

Withholding tax on foreign stocks will be taken into account by the paying agents and offset.



2.4.3. Module 3 – Collective investments

To make things simple, collective investments will be covered by a special module.

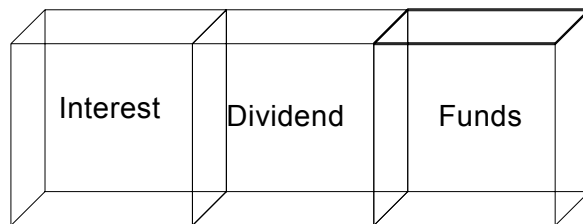
A potential proposal for the taxation of collective investments must be defined in detail on the basis of the bilateral agreements, taking the aspect of simplicity into account. The aim should be to present a proposal which is simple to handle and meets the requirements of as many countries as possible.

For collective investments the general rule applies that the investment should be taxed on its distributions or on the realised gains or losses (Δ NAV).

The principle of transparency applies. If a collective investment scheme can distinguish the share of interest and dividends from gains and losses in its statements to clients, it would be possible to offset a specifically reported capital loss against a capital gain. Losses on non-transparent investments cannot be offset.

Distribution funds are generally taxed on the basis of distributions (regardless of whether they consist of interest, dividends, income from derivatives or capital gains). On the sale of the investment or partial repayment, the resulting gain or loss is taxed.

Accumulation funds are taxed upon sale of the units, that is, upon realisation of any gain or loss. Partial redemptions are taxed similarly to capital gains.



2.4.4. Module 4 – Capital gains and losses

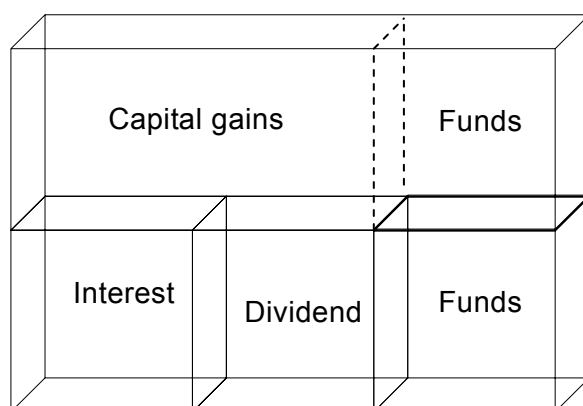
In Italy today, capital gains are taxed and paid directly via the custodian. In Germany, the banks perform this service directly. The technical instruments for this are already available on the market.

Besides taxing interest and dividend payments, the paying agent calculates the gain on the sale of individual instruments and deducts the tax due from the client's account. Where transactions result in a loss, this will be offset against any gains made by the client on other transactions. Capital losses may not be offset against dividends and interest payments.

Where the balance is negative, in other words where there is a net loss in any tax year, the paying agent credits the client with a tax loss carryforward which may be offset against any future gains during a certain period (such as three or five years).

When calculating the tax on individual products there are already a multitude of different approaches being used today in various countries. It is a pre-condition for the Swiss banks that everyone agrees on a single approach that calculates, for instance, the gain on the individual products based on the prevailing market price or the average price (net asset value) or the effective distribution.

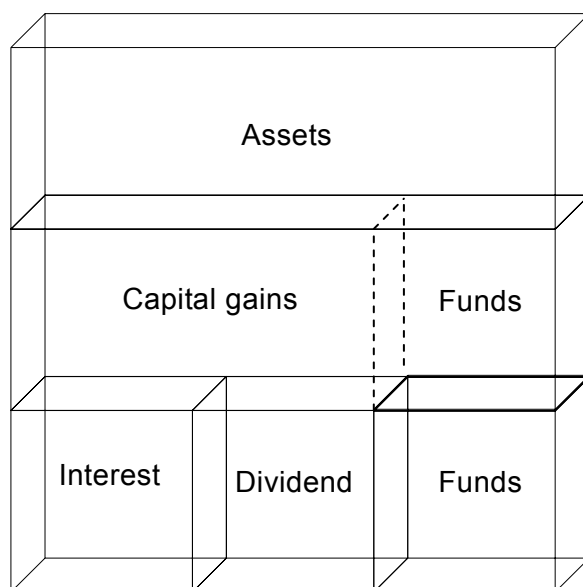
For complex structure products a transparent approach should be applied. If the issuer of the product is able to distinguish interest, from a premium and/or the market value, they can then divide the product along the same lines and make the appropriate offsets. If the product is not transparent, all payments will be taxed using the interest module.



2.4.5. Module 5 – Assets

Certain countries have a wealth tax. This could be levied directly on the client's assets as at 31 December of each year and transferred anonymously.

If assets are taxed at a progressive rate, a flat rate would ideally have to be applied.



2.5. Voluntary disclosure

Similar to the provisions of the EU Savings Tax Agreement, clients with assets deposited at Swiss banks should have the option to report their tax data in full instead of paying the flat rate withholding tax.

The Swiss paying agent collects the data on the basis of a written agreement with the client and transfers them to Federal Tax Administration for onward transmission to the relevant tax authority abroad.

3. Reciprocal demands

Today there are limitations on or special requirements and conditions for access by financial services providers to the markets of diverse EU member states under their national laws. When the flat rate tax model is incorporated into international agreements with individual countries it must be accompanied by:

- the removal of restrictions on access to the markets of those states with whom the flat rate tax model is implemented and
- an end to the criminalisation of clients and Swiss banks.

Annex – Summary of key data

1. Tax subject

- **natural** persons who receive **income from capital investments**
- domiciliary companies, domestic and foreign legal entities, companies, *Anstalten* (establishments), foundations, fiduciary companies or similar associations that do not engage in any commercial or manufacturing business or any other form of commercial operation and of which natural persons are the beneficial owners.
- Trusts: The trustee must in all cases complete a form stating which parties to the trust become liable to tax under prevailing law and when.
- **Does not** apply to
 - corporations (public limited companies, limited companies)
 - operating assets (which are taxed via income tax), i.e. if the income of natural persons from capital investments is attributable to other types of income (commercial income, income from freelance professional activities)
 - charitable organisations, etc.

2. Taxation period

No limitation of taxation to a date, i.e. capital gains that go back 30 years will also be included. The defined calculation methods must be simple.

3. Statement of loss/loss carryforward

3.1. Application

Losses can only be offset in module 3, but capital gains and dividends and interest cannot be offset against each other.

3.2. Period for loss carryforward

5 years

3.3. Certificate of loss (within/outside CH)

General rule: losses may be offset against gains at the level of the client master number.

4. Instruments

Generally the capital gain from an investment should be calculated as the difference between the average price (or NAV) and the selling price.

Distributions, partial redemptions and liquidations are taxed directly on a net basis.

4.1. Equities

Tax is levied based on the historical average price.

4.2. Fixed-income investments

General rule: the provisions of the Savings Tax Agreement continue to apply.

Additionally: realised gains on bonds are taxed via module 3.

4.3. Currencies/index

Currency gains: effectively reported gains/losses

Foreign exchange/notes and coins – no tax

Index: see derivatives

Currency gains on securities are reported separately.

4.4. Certificates/derivatives

Look-through approach: If the issuer of the product is in a position to distinguish interest from a premium or the market value, they can separate these at the level of the product and offset them. If the product is not transparent, all payments are made via the interest module.

Effective hedge: Is offset, also in the case of interest/dividends. Δ NAV of the underlying transaction with the hedge applies. The effective hedge may possibly be offset via the portfolio.

4.5. Collective investments

Transparency principle: If a collective investment scheme is able to distinguish in its statements to clients the portion of interest and dividends from capital gains or losses, a specifically reported capital loss may be offset against the capital gain. Losses on non-transparent investments cannot be offset.

Distribution fund: coupon or cash

Accumulation fund: Δ NAV

Real estate fund: Δ NAV

5. Delivery free of payment

With subrogation of creditors – like a sale with profit realisation

Without subrogation of creditors – master data can be transferred

6. Deductions

Bank charges/fees deductible

7. Foreign withholding taxes

Can be offset within same paying agent.