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Swiss Court Denies Tax Treaty Benefits To Long Borrower of Swiss Shares

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On 20 December 2016 the Federal Administrative Court ("FAC") upheld a decision by the Swiss Federal Tax Administration ("SFTA") to reject the tax treaty-based partial refund claims of a Luxembourg resident financial insti-tution (hereafter called "LuxBank") for Swiss taxes ("WHT") withheld from dividends paid on stock exchange listed Swiss shares, which LuxBank had borrowed from an affiliated financial institution resident in the UK ("UKBank") under standardized securities lending and borrowing ("SLB") contracts.

The FAC essentially found that the Swiss tax treaty with Luxembourg could not be applied, based on its conclusion that LuxBank was not the beneficial owner of the dividends, as LuxBank was contractually required under the SLB arrange-ments to make "manufactured payments" to UKBank. In the FAC's opinion, this resulted in a passing-on of the dividend benefits to per-sons that are not entitled to any benefits from the tax treaty between Luxembourg and Switzerland.

A Facts and legal positions taken by the parties

1 The dividends in question arose whilst LuxBank was holding the Swiss shares under the SLB arrangements with UKBank. 35% Swiss WHT was routinely de-ducted from the gross dividends. UKBank or its parent issued tax vouchers to LuxBank, certifying the amount of Swiss tax withheld. LuxBank made dividend compensation ("manufactured") payments to UKBank, presumably representing a fraction of approximately 85% of the gross original dividends. LuxBank subse-quently filed refund requests for 20% of the gross dividends to the SFTA, using the applicable tax reclaim form no. 79 in accordance with the Luxembourg-Switzerland Double Taxation Treaty ("DTT-Lux"). This would have left a residual, non-refundable Swiss WHT burden of 15%, as is anticipated under the DTT-Lux for portfolio dividends. The reclaim forms referred to the existence of SLB ar-rangements and the fact that LuxBank had received the original dividends.

2 After lengthy correspondence the SFTA rejected the WHT refund requests, essentially arguing that LuxBank was not the beneficial owner of the dividends. The SFTA viewed the SLB transactions as "collateralized debt financing", whereby the Swiss equities had merely been transferred to LuxBank as collateral for cash loans. The SFTA determined that UKBank had acquired the Swiss equities from other market participants in the UK, but had then failed to disclose further infor-mation on the sources of these equities, and that LuxBank was therefore contrac-tually bound to pass on the dividends received to the stock lender. In addition, the SFTA noted that the SLB contracts had only a very short duration.

3 In its appeal to the FAC, LuxBank maintained that it constantly borrowed Swiss equities from UKBank against cash collateral, which was a long-term and profita-ble business activity. LuxBank also argued that it held the borrowed equities in its own name and not as agent or intermediary for any third party; that the Swiss equities giving rise to the WHT reclaims represented only about 10% of all Swiss equities traded over the period of a year; that 78% of all borrowed Swiss equities

were not held over dividend dates; and that the favourable tax environment in Luxembourg was a key factor for concentrating equity finance activities of the group in that location. LuxBank also provided a detailed description of the economics and background of the SLB transactions.

4 During the appeal process the SFTA eventually acknowledged that LuxBank became the legal owner of the Swiss equities under the stock loans; however, the SFTA requested dismissal of the appeal as LuxBank refused to provide sufficient information (on the ultimate customers of UKBank), hence LuxBank's beneficial ownership was not proven, especially in view of the passing-on of 85% of the gross dividends to UKBank via the manufactured payments. In addition, the SFTA asserted that LuxBank was abusing the DTT-Lux.

5 The FAC opted to suspend the trial until such time as the Federal Supreme Court had published its reasoned judgments issued on 5 May 2015 on a total return swap ("TRS") case and a futures case, both involving WHT reclaims made by Danish banks under the former Swiss tax treaty with Denmark, on which the FAC invited the parties to comment. Whilst LuxBank pointed to various differences between the TRS and futures situations on the one hand and its own SLB arrangements on the other, the SFTA insisted on defending its position that the SLB transactions in this instance failed to qualify as "classical" SLB, but rather constituted collateralized cash loans. The SFTA determined that the SLB standard Global Master Stock Lending Agreement (GMSLA) had been modified by the parties in several respects and concluded that LuxBank was not entitled to invoke the SFTA's Circular no. 13 (concerning SLB and repo transactions) in its favour.

6 In response to the SFTA's brief, LuxBank provided two independent expert opinions to support the SLB character of its arrangements made with UKBank and, in addition, disclosed the identities of the counterparties of UK Bank, from and to which UKBank had acquired and eventually transferred back the relevant Swiss equities.

B Considerations of the Court

7 **The FAC essentially agreed with the SFTA and refused to grant LuxBank the benefits under the DTT-Lux on grounds of lacking beneficial ownership**

8 The FAC first pointed to the explicit beneficial owner requirement ("bénéficiaire effectif") included in the dividends article of the DTT-Lux as a condition precedent for any tax treaty benefits. Furthermore, the FAC broadly referred to Swiss and international doctrine (Klaus Vogel et al.) as well as the aforementioned Supreme Court judgments of 5 May 2015 ("Denmark cases") concerning the meaning of the beneficial owner notion in the context of tax treaty application. In particular, the FAC stressed the importance of the intensity of the relations between a taxpayer and the income for which the treaty benefit is sought, which is measured

particularly by the degree of economic control and decision making power over the income held by the income recipient with regard to the use and application of that income. A recipient may be regarded as the beneficial owner, if it holds at least some control over the income application at the time the income arises. On the other hand, no beneficial ownership is held where the recipient is already contractually bound to pass on the income at the moment it is paid out. The FAC pointed to the theory of "mutual dependency" between the receipt of the income and the obligation to pass the income benefit on to another person to establish a so-called "de facto obligation" restricting the recipient's decision making power, which is derived from factual circumstances. The FAC stressed that the "second dependency", i.e. the requirement that the passing-on obligation must be contingent on the actual receipt of the income, is meant to establish reasonable differentiations in intra-group situations. The FAC considered specifically that "not every group-internal financing" will per se remove the beneficial ownership quality of the financed group entity; however, in the FAC's view, situations where the debt service is contingent on the actual receipt of relevant (dividend) income are problematic.

9 Furthermore, the FAC held that the allocation of risks among the parties of stock trade transactions (including in particular price risks and credit risks) is an important factor to determine beneficial ownership of the (dividend) income. Referring to the swaps ruling of the Federal Supreme Court, the FAC pointed out that such risks are not only absent where the on-payment obligation is outright contingent on the receipt of the income, but also where such a risk is in fact sufficiently compensated for. Moreover, concerning the quantum of the passing-on payment, the FAC underlined that a full passing-on of the income is not required to remove beneficial ownership, in particular where a relatively small fraction of retained income is to be considered as service remuneration for the passing-on of the balance.

10 The Court went on to analyse the specific SLB transactions in more detail. The Court generally remarked that SLB transactions are quite commonly used in the financial markets to cover open stock delivery obligations of a borrower who is short in the underlying securities. According to the FAC, stock loans are usually secured with collateral in cash or other securities. Usually, the borrower is contractually entitled to cash to the extent of the original dividend or interest return arising on the securities, minus a borrowing fee in the lender's favour. The FAC pointed to special problems arising in connection with relief from withholding tax, where a stock loan runs over a dividend date. The issues derive from the fact that the banking system generates multiple dividend credit advice statements with certification of WHT deducted ("tax vouchers") - namely for the original dividend credited to the borrower's account, as well as for the manufactured payment credited to the lender's account – whereas possibly only one WHT payment is effectively being deducted and submitted to the SFTA from the original dividend, Moreover, such stock loans may raise questions around the beneficial ownership of the securities and the dividends paid thereon.

11 The FAC referred to SFTA Circular no. 13, published on 1 September 2006, which is designed to prevent undue tax benefits arising from SLB (and repo) transactions. Circular 13 intends in particular to prevent undue, multiple WHT reclaim benefits. To that end, Circular 13 requires Swiss borrowers (if any) of Swiss shares and bonds to deduct a "secondary WHT" corresponding to 35% of the gross amount of the original dividend (or bond interest) from the manufactured payment made to the securities lender, and to submit such amount to the SFTA. This is meant to enable both the borrower and the lender to reclaim Swiss WHT separately and independently from one another, within the framework of either Swiss domestic laws or international tax treaties that may govern such tax reclaims. The FAC pointed out that "… where Swiss WHT is effectively paid twice and both parties to the SLB arrangement are reclaiming Swiss WHT separately and independently, the risk of multiple tax refunds appears to be removed and accordingly, in such situations there is no need to decide whether the lender or the borrower of the securities would be the beneficial owner of the original dividend".

12 The FAC briefly mentioned the doubts raised by some Swiss scholars with regard to the legality of the regulation contained in Circular 13, in respect of the levy of a "secondary WHT" on the manufactured payment. However, the Court considered that it was not necessary to discuss those regulations further, given that in the case at hand, the borrower (LuxBank) was neither Swiss resident, nor had it deducted or submitted to the SFTA any "secondary" WHT from the manufactured payments made to UKBank. In essence, the FAC stressed that LuxBank could not derive any benefits or construct any legal arguments from the Circular no. 13. The Court first elaborated on the nature of Circular 13 as an administrative regulation, which is designed to ensure a consistent interpretation and application of tax laws by the competent tax authorities. Such general regulations are binding upon the tax authorities, unless they include an apparent violation of statutory or constitutional law. However, the judicial authorities are not legally bound by merely administrative regulations, even though judicial authorities would generally take such regulations into account and would not deviate from them without compelling reasons.

13 The Court further addressed the principle of protection of good faith in public law, whereby citizens in principle have a right to good faith protection with regard to confirmation statements issued by the competent public authorities, or equivalent behavior of the authorities. However, that principle is subject to far reaching limitations in matters of fiscal law, emanating from a strict legality principle. In particular, oral or written information on fiscal consequences issued by the competent fiscal authorities must refer to concrete, specified, individual situations of a taxpayer, in order to be able to form the basis of any good faith protection of a taxpayer that has relied on such information when implementing a legal structure or transaction. Mere circulars, guidance notes and similar written communications of a general nature issued by the tax authorities are generally not a sufficient basis for such individual good faith protection.

14 The concrete SLB transactions were all based on a GMSLA concluded between LuxBank and UKBank on 23/1/2007, which was later amended four times. All stock loans were secured by cash collateral; the contract amendments all concerned the cash collateral and its calculation. Initially, the cash collateral had to correspond to the market value of the borrowed securities, plus a 5% margin. Later on, the margin was reduced to 0%. Another amendment concerned the minimum cash collateral, which eventually was defined as a fixed amount corresponding to the market value of the borrowed securities upon entry into the transaction, which was increased later on. The agreement provided for compensation (manufactured) payments for the dividends, the amount of which corresponded to the lender's dividend return, had it not lent the securities to LuxBank. In return the lender had to compensate the borrower fully for the interest on the cash collateral that would have accrued to the lender, had no collateral been provided. Mutual fees were agreed covering the lending of the equities and the cash collateral provision.

15 The SLB transactions at issue were all entered into shortly before the dividend payment dates of the underlying equities. The terms of the transactions were 9-13 days. LuxBank was a "long borrower" on the dividend dates, i.e. the relevant equities were not transferred any further during the terms of the arrangements. The manufactured payments had to put the lender in the same financial position it would have been in, had it not lent the shares to LuxBank.

16 One of the main arguments used by LuxBank in the trial was the assertion that it would have owed the contractual manufactured dividends to UKBank even if it had not itself cashed in the original dividends; thus, LuxBank could have transferred the shares further and would still have had to make the manufactured payments; hence it was not "*obliged to pass on the dividends*".

17 However, the FAC dismissed that argument based on the following: First, the Court referred to the possibility of "factual obligations to pass-on" based on de facto limitations, in the meaning of the aforementioned "mutual dependency" between the receipt of dividends and the obligation then to pass them on. The Court considered that the transfers of the shares from UKBank to LuxBank and the contractual obligation to make manufactured payments were all based on one mutual contract (the GMSLA). The Court concluded that, had LuxBank not entered into the GMSLA, the shares would not have been transferred to it, nor would it have been under any obligation to transfer an equivalent number of shares to UKBank at the end of the single transactions – in other words, the transfer of shares was linked to the manufactured payment obligation. The Court concluded further that LuxBank received the dividends in question only because it had entered into the manufactured payment obligation for equivalent amounts under the SLB transactions. "*Without the manufactured payment obligation, [the Claimant] would not have derived the dividends*." Thus, in the opinion of the Court, a mutual dependency between the receipt of the income and the obligation to pass-on the income was given. The Court held further that such a mutual dependency existed also *"… because the Claimant had to make manufactured pay-*

ments only in the event that the issuers, whose stocks were lent and borrowed, actually distributed dividends. Where no dividends were paid, no manufactured payment was due".

18 Furthermore, the Court considered that LuxBank's discretion with regard to the utilization of the borrowed shares was only "fictitious". The Court pointed to the effective long borrowing position of LuxBank in all situations at hand (none of the shares were transferred any further as of the dividend dates). According to the Court, LuxBank's business model did not foresee any further transactions with the borrowed shares. The Court referred to LuxBank's statement that it wanted to benefit from the favourable fiscal conditions in Luxembourg, whilst the lender wanted to take advantage of a favourable tax treatment of the manufactured payments in the UK. Although the FAC had no principled objections against such cross-border tax arbitrage (between Luxembourg and the UK), it showed, according to the FAC, that the sole purpose of the transactions was to ensure that LuxBank could cash in the Swiss dividends in order to pass them on entirely to UKBank – even if that was not explicitly stipulated in the written contracts.

19 The Court also pointed to the absence of any risks for LuxBank (other than the risk of obtaining the WHT refunds), given that all SLB transactions were concluded with one counterparty belonging to the same banking group, that no further transactions with the borrowed shares as at the dividend dates could be proven (thus eliminating both market risk and credit risk), and that all transactions (in particular the cash collateral) were effectively funded by the mutual parent company of LuxBank and UKBank. Based on the overall circumstances of the SLB transactions at hand (mutual, short-term transactions over dividend dates with always the same affiliated counterparty), the Court concluded that the passing-on of the dividends to UKBank was in fact the key driver for LuxBank to enter into the SLB arrangements in the first place. The Court found that LuxBank had in fact no discretion whatsoever with regard to the utilization of the borrowed shares and the dividends, as it had to compensate UKBank fully for the dividends through the manufactured payments, and effectively had to return the equivalent amount of all borrowed shares to UKBank shortly after the dividend dates. On that basis, the Court concluded that LuxBank held no beneficial ownership of the dividends.

C Preliminary Comments

20 At first glance, it appears somewhat disturbing that the FAC held the SFTA's Circular no. 13 to be completely irrelevant in this specific case.

21 Circular 13 explicitly states under Section 3.2, addressing the situation of a non-Swiss resident long borrower, that such foreign long borrowers *"… are entitled to refunds of Swiss WHT deducted from the original (dividend) payment within the framework of applicable double taxation treaties*". It appears to be quite clear in the context of Circular 13 that *any* SLB (or repo) transaction over a dividend (or

interest coupon) payment date principally comes with a certain manufactured payment by the securities borrower (or repo buyer) to the lender (or repo seller) – whatever the contractually agreed amount of the manufactured payment may be. An obligation to impose a "secondary" WHT on the manufactured payment is only foreseen for Swiss resident borrowers, as a condition precedent for the *lender* to reclaim any Swiss WHT (with regard to the manufactured payment).

22 Section 3.2 of Circular 13 explicitly states that, in the event of SLB (or repo) transactions over dividend dates with Swiss securities, a foreign *lender* could only reclaim any Swiss WHT (based on applicable double tax treaties), where an actual payment of Swiss WHT on the manufactured payment could be proven (which would normally not be the case, as the foreign borrower is under no obligation to withhold and pay any "secondary" Swiss WHT, neither under Swiss statutory law nor under the Circular no. 13). If the fact of the manufactured payment, replicating the underlying original dividend or a fraction thereof, were to constitute any particular issue for the SFTA, one would normally have expected that the SFTA in its own public communications on tax issues concerning SLB and repos would address such important concerns as beneficial ownership of the original dividend and interest coupons. However, Circular 13 does not include any such indications, other than the general reference to the "framework of applicable double taxation treaties".

23 We believe that the FAC's judgment can only be explained against the background of the very specific facts of the case at hand, involving completely bilateral transactions between two affiliated parties made over short-term periods over Swiss dividend dates. The transactions effectively allowed UKBank to replace the receipt of original Swiss dividends, which would have come with a 35% WHT deduction, with receipts of manufactured dividends paid by a non-Swiss borrower, from which no Swiss tax had to be deducted. The manufactured payments at the level of 85% of the original dividends (reflecting the borrower's expectation to reclaim 20% Swiss WHT, leaving a 15% residual WHT burden pursuant to the DTT-Lux) could be priced into UKBank's arrangements with its own clients, from whom UKBank had sourced the shares. Whilst LuxBank as a borrower was expected to rely on the SFTA's Circular no. 13, Section 3.2 when claiming back some of the Swiss WHT under the DTT-Lux, UKBank would not have needed to reclaim any Swiss WHT and would therefore not have been exposed to any questions by the SFTA in terms of beneficial ownership, tax treaty abuse and so forth.

24 It remains to be seen whether this case will be referred to the Federal Supreme Court via a public law appeal, and if so, what the reasoning of the Supreme Court will be.

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