Switzerland

Court Denies Tax Treaty Benefits to Long Borrower of Swiss Shares

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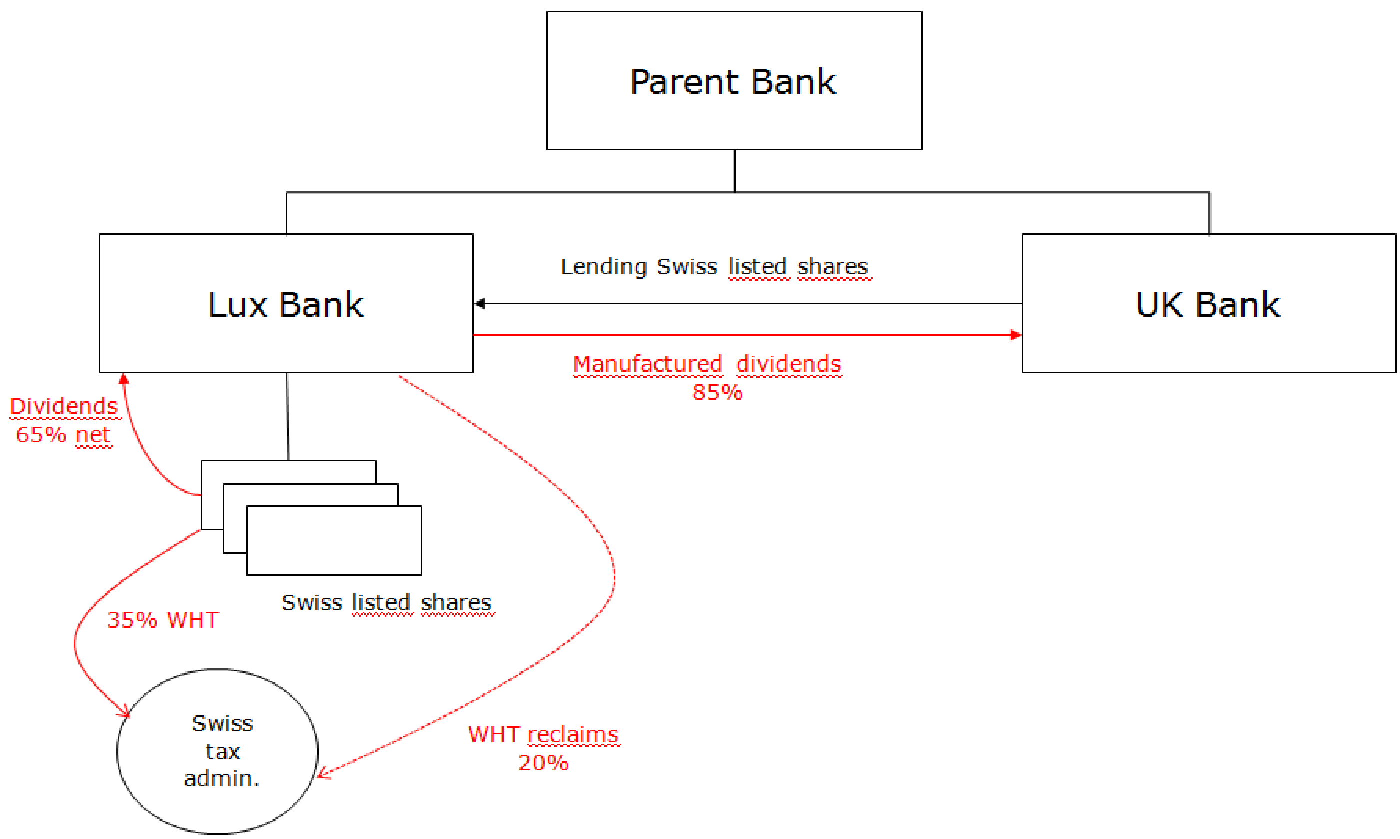
The Swiss Federal Administrative Court upheld a decision by the Federal Tax Administration to reject the tax treaty-based partial refund claims of a Luxembourg resident financial institution for Swiss withholding tax on dividends paid on stock exchange-listed Swiss shares, which Lux Bank had borrowed from an affiliated financial institution resident in the United Kingdom.

1. Introduction

On 20 December 2016 the Federal Administrative Court (*Bundesverwaltungsgericht*) upheld a decision by the Swiss Federal Tax Administration (SFTA) to reject the tax treaty-based partial refund claims of a Luxembourg resident financial institution (Lux Bank) for Swiss taxes (withholding tax) withheld from dividends paid on stock exchange-listed Swiss shares, which Lux Bank had borrowed from an affiliated financial institution resident in the United Kingdom (UK Bank) under standardized securities lending and borrowing (SLB) contracts.[1]

Figure 1



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1. CH: BVGer, 20 Dec. 2016, Judgment A-1426/2011.

The Court essentially found that the Swiss tax treaty with Luxembourg (the Treaty) could not be applied, based on the Court's conclusion that Lux Bank was not the beneficial owner of the dividends, as Lux Bank was contractually required under the SLB arrangements to make "manufactured payments" to UK Bank. In the Court's opinion, this resulted in a passing-on of the dividend benefits to persons that are not entitled to any benefits under the Treaty.

2. Facts and Legal Positions Taken by the Parties

The dividends in question arose whilst Lux Bank was holding the Swiss shares under the SLB arrangements with UK Bank. Swiss withholding tax of 35% was routinely deducted from the gross dividends. UK Bank or its parent issued tax vouchers to Lux Bank, certifying the amount of Swiss tax withheld. Lux Bank made dividend compensation (manufactured) payments to UK Bank, presumably representing a fraction of approximately 85% of the gross original dividends. Lux Bank subsequently filed refund requests for 20% of the gross dividends to the SFTA, using the applicable tax reclaim Form 79 in accordance with the Treaty. This would have left a residual, non-refundable Swiss withholding tax burden of 15%, as is anticipated under the Treaty for portfolio dividends. The reclaim forms referred to the existence of SLB arrangements and the fact that Lux Bank had received the original dividends.

After lengthy correspondence, the SFTA rejected the withholding tax refund requests, essentially arguing that Lux Bank 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 Lux Bank as collateral for cash loans. The SFTA determined that UK Bank had acquired the Swiss equities from other market participants in the United Kingdom, but had then failed to disclose further information on the sources of these equities, and that Lux Bank was therefore contractually 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.

In its appeal to the Federal Administrative Court, Lux Bank maintained that it constantly borrowed Swiss equities from UK Bank against cash collateral, which was a long-term and profitable business activity. Lux Bank also argued that:

- it held the borrowed equities in its own name and not as agent or intermediary for any third party;
- the Swiss equities giving rise to the withholding tax reclaims represented only approximately 10% of all Swiss equities traded over the period of a year;
- 78% of all borrowed Swiss equities were not held over dividend dates; and
- the favourable tax environment in Luxembourg was a key factor for concentrating equity finance activities of the group in that location.

Lux Bank also provided a detailed description of the economics and background of the SLB transactions.

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

The Federal Administrative Court opted to suspend the trial until such time as the Federal Supreme Court published its reasoned judgments issued on 5 May 2015 on a total return swap case and a futures case, both involving withholding tax reclaims made by Danish banks under the former Swiss tax treaty with Denmark, on which the Federal Administrative Court invited the parties to comment. Whilst Lux Bank pointed to various differences between the total return swap and futures situations on the one hand and its own SLB arrangements on the other, the SFTA insisted on defending their 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 Lux Bank was not entitled to invoke Circular 13 issued by the SFTA (Circular 13) (concerning SLB and repo transactions) in its favour.

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

3. Considerations of the Court

The Court essentially agreed with the SFTA and refused to grant Lux Bank the benefits under the Treaty on grounds of lacking beneficial ownership.

3.1. Mutual dependency of payment

The Federal Administrative Court first pointed to the explicit beneficial owner requirement (*bénéficiaire effectif*) included in the dividends article of the Treaty as a condition precedent for any tax treaty benefits. Furthermore, the Court broadly referred to Swiss and international literature (Klaus Vogel et al.) as well as the aforementioned Supreme Court judgments of 5 May 2015 (the Denmark cases)[2] concerning the meaning of "beneficial owner" in the context of tax treaty application. In particular, the Federal Administrative Court stressed the importance of the intensity of the relations between a taxpayer and the income for which the treaty benefit is sought, 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 Federal Administrative Court 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 Court stressed that the "second dependency" (i.e. the requirement that the passing-on obligation be contingent on the actual receipt of the income) is meant to establish reasonable differentiations in intra-group situations. The Court considered specifically that "not every group-internal financing" will per se remove the beneficial ownership quality of the financed group entity; however in the view of the Court, situations where the debt service is contingent on the actual receipt of relevant (dividend) income are problematic.

3.2. Allocation of risk

Furthermore, the Court held that the allocation of risks among the parties to stock trade transactions (including, in particular, price risks and credit risks) is a significant factor to determine beneficial ownership of the (dividend) income. Referring to the swaps ruling of the Federal Supreme Court, the Federal Administrative Court pointed out that such risks are absent not only 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. Moreover, concerning the quantum of the passing-on payment, the Federal Administrative Court emphasized 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.

3.3. Problem of manufactured payments and tax vouchers: Secondary withholding tax

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 that is short in the underlying securities. According to the Federal Administrative Court, 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 Court pointed to special problems arising in connection with relief from withholding tax, where a stock loan runs over a dividend date. The issues arise from the fact that the banking system generates multiple dividend credit advice statements with certification of withholding tax 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 withholding tax payment is effectively deducted and submitted to the SFTA from the original dividend. Moreover, such stock loans may raise questions as to the beneficial ownership of the securities and the dividends paid thereon.

The Federal Administrative Court referred to Circular 13, titled "Securities Lending" and published on 1 September 2006, which is designed to prevent undue tax benefits arising from SLB (and repo) transactions. Circular 13 aims in particular to prevent undue, multiple withholding tax reclaim benefits. To that end, Circular 13 requires Swiss borrowers (if any) of Swiss shares and bonds to deduct a "secondary withholding tax" 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 withholding tax separately and independently from one another, within the framework of either Swiss domestic law or an applicable international tax treaty that may govern such tax reclaims. The Court pointed out that:

> [...] where Swiss withholding tax is effectively paid twice and both parties to the SLB arrangement are reclaiming Swiss withholding tax 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.[3]

The Court 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 withholding tax" 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 (Lux Bank) was neither Swiss resident, nor had it deducted or submitted to the SFTA any "secondary" withholding tax from the manufactured payments made to UK Bank. In essence, the Court stressed that Lux Bank could not derive any benefits or construct any legal arguments from Circular 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.

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2. CH: BGer, 5 May 2015, Judgments 141 II 447 and 2C_895/2012. *See* P. Reinarz & F. Carelli, *Court Rulings on Dividend Stripping and Denial of Swiss Tax Treaty Benefits*, 18 Derivs. & Fin. Instrums. 4 (2016), Journals IBFD.
3. Judgment A-1426/2011, consideration 4.3.

3.4. Principle of good faith

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 behaviour of the authorities. However, this principle is subject to far-reaching limitations in matters of tax law, emanating from a strict legality principle. In particular, oral or written information on tax consequences issued by the competent tax 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.

The concrete SLB transactions were all based on a GMSLA concluded between Lux Bank and UK Bank on 23 January 2007 and 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 later increased. 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 Lux Bank. 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.

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. Lux Bank 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 Lux Bank.

3.5. Obligation to pass on the dividend

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

However, the Court rejected 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 UK Bank to Lux Bank and the contractual obligation to make manufactured payments were all based on one mutual contract (the GMSLA). The Court concluded that, had Lux Bank 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 UK Bank 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 Lux Bank 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 payments only in the event that the issuers, the shares of which were lent and borrowed, actually distributed dividends. Where no dividends were paid, no manufactured payment was due".[4]

Furthermore, the Court considered that Lux Bank's discretion with regard to the utilization of the borrowed shares was only "fictitious".[5] The Court pointed to the effective long borrowing position of Lux Bank in all situations at hand (none of the shares were transferred any further as of the dividend dates). According to the Court, Lux Bank's business model did not foresee any further transactions with the borrowed shares. The Court referred to Lux Bank'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 United Kingdom. Although the Court had no principled objections against such cross-border tax arbitrage (between Luxembourg and the United Kingdom), it showed, according to the Court, that the sole purpose of the transactions was to ensure that Lux Bank could cash in the Swiss dividends in order to pass them on entirely to UK Bank – even if that was not explicitly stipulated in the written contracts.

The Court also pointed to the absence of any risks for Lux Bank (other than the risk of obtaining the withholding tax refunds),[6] 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 Lux Bank and UK Bank. 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 UK Bank was, in fact, the key driver for Lux Bank to enter into

4. Judgment A-1426/2011, consideration 5.2.2.3, 3rd para.
5. Judgment A-1426/2011, consideration 5.2.2.3, 4th para.
6. Judgment A-1426/2011, consideration 5.2.2.4.

the SLB arrangements in the first place. The Court found that Lux Bank had, in fact, no discretion whatsoever with regard to the utilization of the borrowed shares and the dividends, as it had to compensate UK Bank fully for the dividends through the manufactured payments, and effectively had to return the equivalent amount of all borrowed shares to UK Bank shortly after the dividend dates. On that basis, the Court concluded that Lux Bank held no beneficial ownership of the dividends.

4. Preliminary Comments

At first glance, it appears somewhat disturbing that the Court held Circular 13 to be completely irrelevant in this specific case.

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 withholding tax 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" withholding tax on the manufactured payment is only foreseen for Swiss resident borrowers, as a condition precedent for the *lender* to reclaim any Swiss withholding tax (with regard to the manufactured payment).

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 reclaim any Swiss withholding tax (based on an applicable income tax treaty), only where an actual payment of Swiss withholding tax 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 withholding tax, neither under Swiss statutory law nor under Circular 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 their own public communications on tax issues concerning SLB and repos would address such significant 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".

In the authors' opinion, the judgment of the Federal Administrative Court can be explained only 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 UK Bank to replace the receipt of original Swiss dividends, which would have come with a 35% withholding tax 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 withholding tax, leaving a 15% residual withholding tax burden pursuant to the Treaty) could be priced into UK Bank's arrangements with its own clients, from which UK Bank had sourced the shares. Whilst Lux Bank as a borrower was expected to rely on Circular 13, section 3.2 when claiming back some of the Swiss withholding tax under the Treaty, UK Bank would not have needed to reclaim any Swiss withholding tax and would therefore not have been exposed to any questions by the SFTA in terms of beneficial ownership, tax treaty abuse and so forth.

The ruling of the Court was appealed by the taxpayer; it remains to be seen how the Supreme Court will deal with this case. In the meantime, it has become known that the SFTA are working on significant changes to Circular 13 with regard to the person that will, in future, be regarded as being principally entitled to reclaim Swiss withholding tax deducted from the original dividend of shares that are subject to a lending or repo arrangement over the dividend date – namely, the lender if it can prove that it has been passed on the original dividend, and if it meets all general conditions for withholding tax reclaims. It is expected that the revised Circular 13 will be published in the second half of 2017.