Federal Supreme Court Denies Beneficial Owner Capacity of a Borrower of Swiss Shares Over a Dividend Payment Date

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With a judgment rendered on 16 December 2019 (case no. 2C_209/2017), the Swiss Federal Supreme Court ("FSC") rejected several reclaims of Swiss dividend withholding taxes made by a Luxembourg resident financial institution ("Lux Bank") and thereby denied the claimant the benefits of the double taxation treaty between Switzerland and Luxembourg on income and capital taxes ("CH-Lux DTT"). The FSC in essence confirmed the decision of the Federal Administrative Court (the prior judicial instance) dated 20 December 2016, which had denied Lux Bank the tax treaty benefits on grounds of lacking beneficial ownership of the dividends in question.[1] Lux Bank had been holding the listed shares giving rise to the Swiss withholding tax deductions in question on the respective dividend payment dates under entered into with an affiliated financial institution based in the United Kingdom ("UK Bank"). According to the contractual terms of the SLB arrangement, the Lux Bank had to pay certain "manufactured dividends" to the lender of the shares (the UK Bank).

Summary of Facts

The general background of the case was a standardised securities lending and borrowing (SLB) arrangement between Lux Bank and a financial institution based in the United Kingdom ("UK Bank"), a sister company of Lux Bank. Both entities were controlled subsidiaries of a listed company in the UK. In the year 2009, Lux Bank held significant positions in several Swiss listed shares, which it had borrowed from UK Bank. Lux Bank derived dividends from some of its borrowed Swiss share positions, from which the Swiss issuers deducted federal withholding taxes at the statutory tax rate of 35%. Pursuant to the SLB contracts, Lux Bank had to make certain dividend compensation ("manufactured dividend") payments to UK Bank. The manufactured dividends corresponded to 85% of the gross original dividends. After receipt of the net dividends (65% of the gross amounts), Lux Bank filed refund request forms with the Swiss Federal Tax Administration (FTA), claiming refunds of 20 percentage points out of the 35% taxes withheld from the original dividends, based on the CH-Lux DTT, article 10 para. 2 letter (a), which generally limits the source country withholding tax on dividends to 15%, where the beneficial owner ("*bénéficiaire effectif*") of the dividends is a resident of the other Contracting State. The FTA eventually refused to satisfy the withholding tax refund requests (totaling about CHF 54.6 million), arguing that the "stock loans" were effectively collateralized cash loans (the SLB contract *inter alia* provided that Lux Bank had to provide cash collateral with a certain margin to UK Bank for the borrowed Swiss shares) and concluding that Lux Bank was not the beneficial owner of the dividends arising on the "borrowed" shares, which the FTA treated as mere collateral for a cash loan.

Upon Lux Bank's appeal against the FTA's refusal to grant the requested withholding tax refunds, the Federal Administrative Court ultimately concurred with the FTA's conclusion that Lux Bank could not be regarded as the beneficial owner of the dividends arising on the borrowed shares. In essence, the Administrative Court found that under the contractual arrangement with UK Bank, Lux Bank did not have sufficient economic control and decision-making power with regard to the use and application of the dividend income, as upon receipt of the dividends it was already effectively bound to pass them on to UK Bank through the manufactured payments, and furthermore, Lux Bank was contractually obliged to return an equivalent number of the relevant Swiss shares to UK Bank at the end of the borrowing terms, which were shortly after the dividends had arisen. The Administrative explicitly dismissed the application of the FTA's Circular letter no. 13 concerning Securities Lending in its then applicable version, which provided inter alia that in a situation of "long borrowing" of Swiss shares over a dividend date by a nonresident borrower, such borrower (rather than the lender) would in principle be regarded as the beneficial owner of the dividend.[2]

Considerations of the FSC

The FSC first reiterated that it has to base its judgments on the facts determined by the previous judicial instance, unless that facts determination is apparently wrong (arbitrary) or based on a violation of law. The Federal Administrative court had determined that Lux Bank had been transferred ownership of various Swiss exchange-traded shares shortly before their respective dividend payment dates by UK Bank based on a "Global Master Stock Lending Agreement" (GMSLA). According to that agreement, Lux Bank had to provide cash collateral for an amount equivalent to the aggregate market value of the borrowed shares plus a margin. Further, under the GMSLA Lux Bank had to pay UK bank a dividend compensation (manufactured dividend) whenever it received a dividend on the borrowed shares, whereby the compensation was to put UK Bank financially in the same position (considering dividends and share price fluctuations) , as if it had held on to the shares, rather than lending them to Lux Bank. The FSC explicitly referred to the findings by the Administrative Court, according to which the sole objective of the SLB transactions (i.e. the lending of the shares, the dividend compensation payment and the return of equivalent amounts of shares) was to ensure that the original dividends could be cashed in by Lux Bank and passed on to UK Bank, in order to benefit of a favorable taxation of the dividend compensation in the UK. According to the Administrative Court, this favorable tax treatment in the UK necessitated that Lux Bank would not transfer the shares to any third party (prior to the dividend payment dates), but would rather hold on to the shares, receive the dividends and make equivalent dividend compensation payments to UK Bank. The Administrative Court had concluded that the passing-on of the dividends to UK Bank (via the manufactured dividends) was the key element of the transactions, without which they would not have been entered into the parties.

The FSC stressed that it was principally bound to these factual determinations by the Administrative Court. Lux Bank had attempted to make an argument that the factual conclusions by the Administrative Court were in part apparently wrong, as they did not take into account that Lux Bank had earned interest of some GBP 145 million on the cash collateral provided, which corresponded to nearly 50% of the gross dividend revenues derived from European shares of about GBP 303 million, hence the stock loans were not only tax motivated; moreover, the vast majority of the stock loans with Swiss shares did not involve any dividend payments, and hence did not trigger any dividend compensations; finally, Lux Bank had assumed an array of risks, among them credit risk. However, the FSC determined that Lux Bank had failed to prove that the factual finding of the Administrative Court, that the borrowing of shares, the payment of dividend compensations and the return of equivalent numbers of shares were only tax-motivated, was apparently wrong (art. 97 para. 1 Federal Supreme Court Act); hence the FSC held itself legally bound by these findings (art. 105 para. 1 Federal Supreme Court Act).

The FSC then turned to the interpretation of the provisions of the CH-Lux DTT (in its original version, which was applicable to dividends paid in 2009), in particular the dividend rule of art. 10 para. 2 (a) and the beneficial owner requirement, which is explicitly contained in that provision. According to art. 10, para 1. CH-Lux DTT, dividends paid by companies resident in one Contracting State to a person resident in the other Contracting State may be taxed in that other State. However, according to para. 2(a)(ii) of the same provision, such dividends may also be taxed in the Contracting State of which the paying company is a resident, whereby the tax of the source State must not exceed 15% of the gross dividend, if the recipient thereof residing in the other State is the beneficial owner. The FSC referred to its standing jurisprudence, according to which the interpretation principles for international law, as set out in art. 31 *et seq*. of the Vienna Convention of 23 May 1969 on the Law of Treaties ("TLC") are applicable. In particular, the FSC referred to the interpretation of tax treaty provision in accordance with their general meaning, as determined in good faith in consideration of their context and their objectives ("*effet utile*" of the treaty). The FSC pointed to the literal wording of art. 10 para. 2 (a) CH-Lux DTT, which makes the limitation of the source State's taxation right for the dividend subject to the beneficial owner requirement. Accordingly, the FSC had to review whether Lux Bank could be qualified as the beneficial owner of the dividends it had derived on the borrowed Swiss shares. The FSC referred to its own jurisprudence established with the "Danish banks' cases" in 2015 (FSC judgments 141 II 444, cons. 5, and 2C_895/2012 dated 5 May 2015, cons. 4)[3], which it later extended to other Swiss double taxation treaties, including the CH-Lux DTT and its relevant provision of art. 10 para. 2 (a) (FSC judgments 2C_752/2014 of 27 November 2015, cons. 4.1; 2C_936/2017 of 22 August 2019, cons. 5.3; 2C_964/2016 of 5 April 2017[4], cons. 4.3). According to that jurisprudence, the beneficial owner is the person who can fully enjoy and apply the dividend benefit. Where the dividend recipient is subject to restrictions in such enjoyment and application arising under a statutory or contractual obligation to pass the dividend on to another person, he is not the beneficial owner. In addition, according to the FSC's jurisprudence, a dividend recipient also loses his beneficial owner capacity, where he is only subject to a merely economic, "de facto obligation" to pass-on the dividend. Payment of an amount principally equivalent to the dividend is considered a "pass-on" payment. It is sufficient that the dividend equivalent amount is included in the calculation basis of a total amount, which also takes into account risks and benefits other than the dividend itself, such as compensation for share price fluctuations and for the passing-on service. Thus, a payment of (slightly) less than 100% of the dividend may still be qualified as a "pass-on" payment. The FSC demands a "substance over form" analysis based on all relevant facts and circumstances as of the payment date of the dividend; pass-on payments occurring only after the dividend payment date have to be considered if they were agreed upon prior to the dividend payment date.

Lux Bank had argued before the FSC that the established jurisprudence to that effect was no longer up to date, given that the commentary on art. 10 of the OECD Model Tax Treaty (as far as dividends paid to mere agents or representatives are concerned) was updated on 15 July 2014. The FSC in its judgment referred to the revised version of the OECD commentary, notes 12.1-12.4 on article 10, according to which those persons who receive dividends merely as agents or representatives, as well as so-called "conduit companies", whose decision powers with regard to the dividend application are so narrow that they appear to be mere fiduciaries or administrators acting in the interest of other persons are not considered as beneficial owners. Whereas such limitations of the decision powers usually derive from the underlying contracts, the OECD (in the FSC's words) considers it to be admissible to conclude on the existence of such legal limitations merely based on the circumstances. However, not harmful are those contractual or statutory obligations, which do not depend on the actual receipt of the dividend by the immediate recipient, such as obligations existing regardless of the receipt (or not) of the dividend, which the recipient incurs as a borrower under a loan, as a party to a financial transaction, or as a distributing collective investment vehicle that can principally obtain tax treaty benefits.

The FSC clarified that according to the OECD's opinion, even where a dividend recipient qualifies as a beneficial owner thereof, this would not mean in each and any case that the benefits under art. 10 OECD Model Treaty have to be granted. The tax treaty benefits may still be denied, if there is a case of tax treaty abuse, which is not covered by the beneficial owner concept (Commentary on art. 10 OECD Model Treaty, note 12.5, version of 15 July 2014).

The FSC left the question open, whether the 2014 update on the OECD Model Tax Treaty Commentary was applicable to the case at hand, which concerned dividends arisen in 2009. The FSC stressed that the Administrative Court had not based its conclusion of lacking beneficial ownership of Lux Bank on grounds of a "de facto obligation" to make pass-on payments. Rather, the Administrative Court had reached a conclusion, based on the shared intentions of the parties involved and the general circumstances determined by the Court – in particular, the contractual stipulations regarding the transfer of shares, the dividend compensation payments and the re-transfer of shares of equivalent type and in equivalent amounts all contained in the same written agreement – that there was indeed a *contractual obligation* to make dividend pass-on payments. According to the Administrative Court's finding, any transfer of the relevant shares by Lux Bank to a third party prior to the relevant dividend payment dates would not have been reconcilable with those "implicit" ("*konkludent*") contractual obligations. Therefore, the FSC concludes that the Administrative Court has implicitly characterized Lux Bank as a mere "conduit", which acted only in a fiduciary or administrative capacity with regard to the dividends, and whose contractual obligation to pay a dividend equivalent amount was contingent on the actual receipt of the dividends.

Lux Bank had also argued that it had booked the dividends received as income. However, the FSC considered that this alone would not exclude the possibility that the dividends were not attributable to Lux Bank for income tax purposes, given that it had to pass the dividends on, so that its situation was comparable with the position of a fiduciary. The FSC referred to a judgment of the German *Bundesfinanzhof* of 18 August 2015 (I R 88/13, §21), to the accounting standard for SLB transactions of the International Accounting Standards Board, IFRS 9 "Financial Instruments", notes 3.2.9 and B3.2.5, and to the FINMA Circular 2015/1, "*Rechnungslegung Banken*", dated 27 March 2014, notes 356 *et seq*. But even if the dividends had been attributed to Lux Bank for Luxembourg corporate tax purposes, these revenues would have been compensated entirely or for the most part by corresponding expenses for the manufactured payments. Moreover, the manufactured dividends were paid to an affiliated entity, which was able to benefit of a particularly attractive taxation regime with regard to those payments. The Administrative Court had determined that these tax benefits would not (or not to the same extent) have been available to the UK affiliate, had Lux Bank not passed-on the dividends. The FSC concludes that even if the dividends were principally attributable to Lux Bank, it would still have to be characterized as a "conduit" in the meaning of the OECD's Model Treaty Commentary ("stepping stone strategy", see Commentary note 12.3 on art. 10 OECD Model Treaty, version of 15 July 2014 and its Annex R (6)-3).

Similar to the Federal Administrative Court, the FSC rejected Lux Bank's complaint that the proposed interpretation of art. 10 para. 2 (a) CH-Lux DTT would be contradicting the FTA Circular no. 13/2006, ciph. 3.2, according to which non-Swiss resident borrowers of Swiss shares in SLB transactions are entitled to reclaim the dividend withholding tax. Such administrative regulations address the public authorities; they do not create any new rights of private parties. While these regulations are not binding the legal courts, they can be taken into account for the interpretation of domestic Swiss law. However, the interpretation of international treaties follows the interpretation rules of international law. In any case, an administrative regulation such as the Circular no. 13/2006 would not provide any convincing interpretation of art. 10 para. 2 (a) CH-Lux DTT, to the extent that it would grant a withholding tax refund entitlement to borrowers who are subject to a pass-on obligation for the dividend (as was the case for Lux Bank) and who are, therefore, not to be characterized as beneficial owners.

Finally, the FSC dismissed arguments brought by Lux Bank that the non-application of ciph. 3.2. of Circular no. 13/2006 to its case violated its good faith reliance on that administrative practice and constituted an unjustified, not properly announced change of administrative practice; further, that this amounted to a violation of the constitutional principle of equal treatment (art. 8 para. 1 Federal Constitution) with those stock borrowers that had obtained withholding tax refunds in accordance with the practice set forth in the Circular no. 13/2006. The FSC stressed that the basis for good faith reliance by the citizens is limited to those administrative acts which relate to a concrete, individual matter and stem from a competent authority. Typical examples are individual concrete information or assurances given by a competent authority, subject to some further conditions. However, Circular no. 13/2006 constituted a general-abstract administrative regulation. Deviation by the competent authority from such a regulation in a singular case would be problematic under the good faith reliance aspect only, if the competent authority had given concrete assurances to the taxpayer that the regulation would be applied to his individual case.

Moreover, the FSC held that the conditions for a right to be equally treated with other citizens/taxpayers in comparable situations of wrong application of the law by the competent administrative of judicial authority were not fulfilled. The FSC conceded that there are indeed indications that the FTA had established a practice to refund Swiss withholding tax to securities borrowers residing in foreign tax treaty jurisdictions up to the residual, non-refundable amount pursuant to the tax treaty in question. Such practice would have been illegal, if withholding taxes had been refunded even to such foreign resident borrowers who were subject to a contractual obligation to make dividend pass-on (compensation) payments, as those borrowers would not hold beneficial owner capacity. However, Lux Bank could not derive anything in its favor from such a potential fact. The FTA had not given any indication that it would continue to apply such an illegal practice even after the issuance of a FSC judgment stating the illegality of such practice. Therefore, the FSC had to assume that the FTA would correct its practice and bring it in line with the law based on the judgment at hand. The public interest in the legality of the public administration trumps the private interest of the claimant in being treated equally with other non-resident securities borrowers.

Brief comment

It is remarkable that the Swiss courts had to come to the FTA's help in quashing its own administrative regulation, on which the Lux Bank and its UK resident affiliate had attempted to rely when structuring their SLB transactions. The relevant regulation was indeed partly amended after publication of the ruling of the Administrative Court. It is somewhat surprising that the FTA in its previous administrative guidance had principally conceded a tax treaty-based entitlement to (partial) withholding tax refunds to nonresident borrowers of Swiss securities. In view of the guidance rules pertaining to Swiss resident borrowers of Swiss securities with a dividend (or interest) coupon falling due during the arrangement, it was apparent that the FTA has always been perfectly aware of fact that a securities borrower receiving a coupon payment would generally be contractually required to pay the lender a compensation for the foregone coupon. In order to prevent the FTA's risk of having to refund Swiss withholding tax twice (once to the "long" borrower, and once again to the lender and recipient of the manufactured dividend), while under Swiss statutory law, withholding tax is only applicable to the original dividend, which accrues to the holder of the securities on the dividend payment date, i.e. the "long" borrower), the FTA stipulated an obligation on the Swiss resident payer of the dividend compensation to deduct a "secondary" withholding tax from the compensation – calculated at the statutory rate of 35% on the amount of the underlying original dividend – and to submit such "secondary tax" to the FTA (in the author's view, this does not find any basis in Swiss statutory tax law).

In the Circular no. 13, compliance with this "secondary" withholding tax obligation is stipulated as a condition precedent for the Swiss resident borrower's right to reclaim the withholding tax on the original dividend. However, the FTA considered itself not being competent to impose such a "secondary" tax obligation on nonresident parties (securities borrowers) – but still, it conceded an entitlement in principle to tax treaty based withholding tax refunds to such nonresident borrowers. Following the FTA's own logic, this was a clear mistake. The FTA should have made it clearer at the outset that it effectively made its recognition of the "long borrower's" *beneficial owner capacity* – and hence its ability to reclaim Swiss withholding taxes in principle – contingent on the borrower's readiness to apply yet another 35% withholding tax to the manufactured dividend (compensation) paid to the securities lender[5], because normally, the fact of the manufactured payment would remove the borrower's beneficial owner capacity in respect of the original coupon payment. A non-resident borrower of Swiss securities was never required to apply such a "secondary" tax to its manufactured payment. The FTA should have been more explicit in clarifying that under these conditions, beneficial ownership of the original coupon payment was out of question. It took the Swiss courts to provide that clarification.

[1] Case no. A-1426/2011. A detailed description of the facts of the case and the ruling of the Federal Administrative Court is found in P. Reinarz, Court Denies Tax Treaty Benefits to Long Borrower of Swiss Shares, published online in IBFD, Derivatives & Financial Instruments, 2017 (Vol. 19), No. 3

[2] The FTA's Circular letter no. 13 "Securities Lending" was amended after publication of the ruling of the Administrative Court, effective as of 1 January 2018. The revised version provides *inter alia* that non-Swiss resident "long borrowers" of Swiss securities are no longer to be regarded as the beneficial owners of the (dividend or interest) coupon arising on the securities; rather, the original lender of the securities may be accepted as a beneficial owner, entitled in principle to reclaim Swiss withholding tax, if certain conditions are met. For a detailed description of the revised Circular no. 13, see P. Reinarz and C. Suter, Securities Lending and Repo Transactions: Amended Tax Regulations, published online in IBFD, Derivatives & Financial Instruments, 2018 (Vol. 20), No. 2

[3] A detailed description of the «Danish Banks' cases» is set forth in the article by P. Reinarz and F. Carelli "Switzerland – Court Rulings on Dividend Stripping and Denial of Swiss Tax Treaty Benefits", published online in IBFD, Derivatives & Financial Instruments, 2016 (Vol. 18), No. 4.

[4] This case concerned an Italian bank which had derived dividends from Swiss listed shares, which had been acquired by the Italian bank shortly before the relevant dividend payment dates, and sold again shortly thereafter, and which had been hedged by means of financial derivatives, such as stock options and futures, entered into by the Italian bank with numerous, undisclosed counterparties. As the Italian bank failed to disclose the identity of those counterparties, the FSC (and before it the Federal Administrative Court) concluded that the claimant did not sufficiently comply with its general duty to cooperate with the authorities in establishing the facts relevant to clear up the beneficial owner question, and refused to grant the tax treaty benefits. See P. Reinarz, "Switzerland – Federal Supreme Court Rejects Swiss Withholding Tax Reclaims Made by an Italian Bank under Italy-Switzerland Tax Treaty", published online in IBFD, Derivatives & Financial Instruments, 2017 (Vol. 19), No. 6 for further details.

[5] The practical issue in the market practice lies in the fact that original coupon payments and their certification by financial institutions can hardly be distinguished from mere compensation (manufactured) payments; both can be used as "tax vouchers" to support withholding tax refund requests – which explains the risk on the tax administration's side of having to grant multiple tax refunds, where withholding tax was deducted and paid only once. The FTA reacted by imposing a "secondary" withholding tax obligation on Swiss resident borrowers making compensation payments, in order to indirectly cover its risk. However, this should have been done at the legislative level.