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# Recent development on taxation of securities lending transactions

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January 2016

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**January 2016 / Legal update from Dechert's Tax and Financial Services Groups**

*On 13 January 2016 the German Federal Finance Court (Bundesfinanzhof –"**BFH**") published its ruling on securities lending transactions ("**Ruling**").[1] The Ruling was long-awaited and rumor had it that it might bring about a fundamental change. In the following, we discuss the Ruling, determine its significance and consider its implications.*

## 1. Status Quo

According to the view of the German tax authorities and the prevailing view in tax law literature, the lender transfers under securities lending transactions the tax/economic ownership in the securities to the borrower together with the legal title to the securities.[2] Consequently, for German income tax purposes the income paid on the securities lent is attributed to the borrower. This is irrespective of the fact that, as a rule, securities lending transactions provide for manufactured/substitution payments in relation to the original streams. The BFH has confirmed this view several times in the past.[3] However, there were rumors both within the tax community and the market in general that the BFH may use the above-mentioned case to reconsider its position.

## 2. Ruling

In our view, the Ruling does not provide for a fundamental change even though it disapproves of the transfer of tax/economic ownership of the German borrower in this specific case.

### 2.1 Background

The BFH had to rule in a case of securities lending transactions which were executed in 2006/2007 and designed as tax shelter trades. The tax sheltering effect was anticipated to result from the facts that the dividends received by the German borrower would be effectively 95% tax-exempt while the manufactured dividends payments made by the borrower would be fully tax-deductible creating a loss for corporate income tax purposes of approx. 95% of the gross dividends.[4]

To counteract such structures, the German legislator introduced section 8b para. 10 of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* – "**KStG**") as a specific anti-abuse provision declining the tax-

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1 Docket-no.: I R 88/13. The Ruling can be found at: http://www.bundesfinanzhof.de/entscheidungen/entscheidungen-online.

2 Cf. Federal Ministry of Finance ("**BMF**"), circular letter dated 3 April 1990, DB 1990, p. 863; Higher Tax Authority of Frankfurt, decree dated 15 March 1995, BB 1995, p. 1081; Higher Tax Authority of Bavaria, decree dated 20 July 2010, ESt-Kartei BY § 5 Karte 3.1, BeckVerw 240363; Higher Tax Authority of Frankfurt, decree dated 19 November 2013, DB 2014, p. 454.

3 Cf. Federal Finance Court ("**BFH**"), judgment dated 17 October 2001, I R 97/00, BFH/NV 2002, p. 240; judgment dated 30 June 2011, VI R 37/09, BStBl. II 2011, p. 923; judgment dated 16 April 2014, I R 2/12, BFHE 246, p. 15.

4 Cf. *Häuselmann*, DStR 2007, p. 1379 et seqq.; *Schnitger/Bildstein*, IStR 2008, p. 202 et seqq., in relation to the background of these transactions.

deductibility of the manufactured dividend payments and the lending fees, provided certain tax-arbitrage scenarios exist.[5] The section was only adopted in August 2007 but took effect already as from 1 January 2007.[6]

Therefore, as court of first instance, the Tax Court of Lower-Saxony dealt with the question whether the retrospective application of section 8b para. 10 KStG in the afore-mentioned case was not in compliance with the German Constitution. The Tax Court denied this question reasoning *inter alia* that in this specific case the securities lending transactions are to be considered abusive structures within the meaning of section 42 of the German General Tax Code (*Abgabenordnung* – "**AO**").[7]

### 2.2 Facts and Circumstances

It is important to understand the specific terms and conditions of the securities lending transactions in the said case because both the Tax Court of Lower-Saxony and the BFH based their decisions on these specific details even though the reasoning of each of the courts is different. The relevant terms and cash-flows can be summarized as follows:

| | |
|---|---|
| **Lender** | A UK financial institution |
| **Borrower** | A German manufacturer of machinery organized in the form of a limited liability company (*GmbH*) |
| **Securities** | Shares of UK issuers |
| **Collateral** | Cash |
| **Lending fee** | EUR 305,069, i.e. 2% p.a. of the market value of the securities |
| **Gross dividends** | EUR 9,836,737 |
| **Manufactured dividend payment** | EUR 9,836,737, i.e. 100% of the gross dividends due at the time of the receipt of the dividends |
| **Interest on collateral** | EUR 474,447, i.e. 3.693% p.a. of EUR 25 Mio. |
| **Termination right** | The UK financial institution was entitled to terminate the transactions at any time by giving three days' notice |
| **Effective term** | 14 days, revolving transactions |

In addition, the terms and conditions of the standard framework agreement for securities lending of the German Banking Association (*Deutscher Bankenverband*) were applicable.

### 2.3 Reasoning of Court

Firstly, the BFH confirmed its standing case law in so far as securities lending transactions generally result in the transfer of tax/economic ownership together with the legal title from the lender to the borrower.[8] In this context, the court reiterates that securities lending transactions are also governed by the general principles regarding the

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5 Cf. *Gosch*, in Gosch, Commentary to KStG, 3rd ed., 2015, section 8b, marginal no. 631 et seqq.; *Haisch/Helios*, in Haisch/Helios, Legal compendium financial instruments, 1st ed., 2011, section 4, marginal no. 213 et seqq.

6 Cf. section 34 para. 7 sent. 2 of the German Corporate Income Tax Act (*Körperschaftsteuergesetz* – "**KStG**").

7 Cf. Tax Court of Lower-Saxony, judgment dated 21 November 2013, 6 K 366/12, EFG 2014, p. 494.

8 Cf. marginal no. 19 of the Ruling.

transfer of tax/economic ownership.[9] Pursuant to these principles, the BFH is of the view that the borrower becomes – as a general rule – tax/economic owner of the securities within such lending transaction as he obtains the legal title.

However, in this legal scenario the court decided that – as an exception to the general rule – no transfer of the tax/economic ownership to the borrower had occurred.[10] The BFH bases this conclusion on the specific facts and circumstances of this case and reasons that the borrower only obtained a civil law title in the securities and that, economically, it was an "empty shell".[11] The BFH offers the following reasons[12] for this view:

- Firstly, the borrower did not benefit economically from receiving these dividends. He had to make manufactured dividend payments in the amount of 100% of the received gross dividend. In addition, he had also to pay lending fees to the lender. Finally, there was no benefit for the borrower in terms of liquidity either since the due date of the manufactured dividend payments was the day of the receipt of the dividends.

- Secondly, as lender, the UK financial institution could terminate the transactions at any time by giving three days' notice. Hence, the borrower was effectively not able to exercise voting rights or able to use the equities for on-sales/lending transactions or dispose of them in other ways. In the end, it was not an option for the borrower to make "use" of the securities in any conceivable way.

- Thirdly, the BFH points to the fact that there was no "final" transfer of the risk and rewards associated with the equities to the borrower. In the view of the court, the borrower did not benefit from an increase of value of the equities due to the right of the lender to withdraw from the transaction at any time. Therefore, the borrower did not even obtain the underlying risk and rewards in a "conceptional sense".

- Finally, given the cash-flows summarized above, the entire transaction was pre-tax negative; in this context, the BFH seems to disregard the interest received on the cash collateral to the borrower.[13] So the court concludes that the objective of the borrower was only to acquire a formal position in the equities as to obtain a tax sheltering effect; there was no other economic motivation for executing these transactions.

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[9] According to the general rule of section 39 para. 1 of the German General Tax Code ("**AO**"), tax/economic ownership is – as a matter of principle – attributed to the legal owner. Under sec. 39 para. 2 AO, this only varies in cases where a person other than the legal owner exercises factual control over an asset in such a way that he can exclude the legal owner economically from the control over the asset. On the basis of the case law, tax/economic ownership is to be determined by an analysis applying an overall evaluation. The criteria of the analysis are, in particular, the following: (i) The person is entitled to the income from the asset, (ii) the person is entitled to exercise all major rights attached to the assets, (iii) the person can sell, pledge, loan or otherwise dispose of the asset, (iv) creditors can seize or foreclose the asset and (v) the person has all chances of appreciation and bears all risks of depreciation of the asset and its value. As far as shares/stock are concerned, for a re-allocation of the economic ownership the BFH requires that a person other than the legal owner has a legally protected position to acquire the shares/stock from the legal owner. Cf. the leading cases: BFH, judgment dated 15 December 1999, I R 29/97, BStBl. II 2000, p. 527 and judgment dated 10 March 1988, IV R 226/85, BStBl. II 1988, p. 832.

[10] Cf. marginal no. 18 and 21 of the Ruling.

[11] Cf. at the end of marginal no. 21 of the Ruling.

[12] Cf. marginal no. 21 of the Ruling.

[13] The Tax Court of Lower-Saxony, judgment dated 21 November 2013, 6 K 366/12, EFG 2014, p. 494, had explicitly disregarded the interest in this context.

In line with its decision dated 1 April 2014[14], by using the above-mentioned preconditions the BFH deviates from the principles set out in its leading case dated 15 December 1999[15].[16] In this judgment the court still ruled that the legal entitlement to a disposal – and not the factual possibility to dispose – shall be decisive and that consequently also short term acquisitions trigger the transfer of tax/economic ownership.[17]

Since the BFH denied the transfer of the tax/economic ownership to the borrower the court did not deem it necessary to check whether applying section 8b para. 10 KStG to the present transactions would be anti-constitutional and whether the structure could be disregarded for tax-purposes based on section 42 AO.

### 2.4 Discussion of Ruling

In our view, the Ruling does not provide for a fundamental change of the taxation of securities lending transactions. Instead the BFH has ruled on a singular case where it exceptionally denied the transfer of tax/economic ownership based on specific facts and circumstances.

#### 2.4.1 General Principle

In our view, there can be no doubt that the BFH has not changed its position that securities lending transactions, as a matter of principle, result in a transfer of the tax/economic ownership from the lender to the borrower. In fact, the court confirmed its standing case law in this respect.[18]

No other arguments could be presented because the legal title in the securities is undisputedly transferred[19] within securities lending transactions. Pursuant to the basic rule of section 39 para. 1 AO, however, tax/economic ownership generally follows legal ownership. Therefore, from a dogmatic perspective, situations in which tax/economic ownership remains with the transferor, despite a transfer of legal titles, can only constitute exceptions.[20]

#### 2.4.2 Exceptional Cases

The BFH makes it clear that it decided in a singular case where the tax/economic ownership remained with the lender as exceptions.[21] Since the court had only to examine this specific case, it is not clear which other such cases may also be regarded as an exception. The BFH referred to certain criteria, has however not indicated which of them is significant or decisive.

In our view, the criteria that indicate such exceptional cases in the context of securities lending transactions can be derived from the general principles applied by the BFH. According to the standing case law, in order to

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14 I R 2/12, BFHE 246, p. 15.

15 I R 29/97, BStBl. II 2000, p. 527.

16 Cf. also *Schmid*, DStR 2015, p. 801 ff.

17 Moreover the Ruling does not consider the criterion that the legal owner is exposed to the risk that his creditors can seize or foreclose upon the asset , cf. in this respect BFH, judgment dated 29 November 1982, GrS 1/81, BStBl. II 1983, p. 272.

18 Cf. marginal no. 19 of the Ruling.

19 Cf. marginal no. 20 of the Ruling making reference to BFH, judgment dated 16 April 2014, I R 2/12, BFHE 246, p. 15.

20 Cf. *Pahlke/Koenig*, Commentary to AO, 2nd ed., 2009, section 39, marginal no. 28.

21 Cf. marginal no. 19 of the Ruling.

determine tax/economic ownership one has to apply the "normal course of events", i.e., the typical development of the chosen structure[22] and in our view the typical features of an elected transaction are relevant.[23]

Against this backdrop, in our view the following features speak against/do not speak against the transfer of tax/economic ownership as far as securities lending transactions are concerned:

- Economic participation in income: One criterion that speaks against the transfer of tax/economic ownership is that the borrower within the specific securities lending transactions does not economically benefit from the income on the securities. However, even 100% manufactured/compensation payments[24] as standard features of securities lending transactions[25] do in our view not mandatorily exclude an economic participation in the income. Instead, such an economic participation can be given by the legal owner benefitting from the income on the securities in any other way.[26]

- Rights attached to securities: On the contrary, the fact that the borrower cannot or does not intend to exercise voting rights in relation to listed equities, does in our view not decisively speak against the transfer of tax/economic ownership. This is because the voting rights in relation to listed equities have no real significance given the small participation quotas based on the "normal cause of events". Also, the BFH mentioned the voting rights in the Ruling only once.

- Risk and rewards from securities: In our view, the fact that the risk and rewards from holding the securities are not transferred to the borrower within securities loan transactions does not point to an absence of tax/economic ownership. This is due to the fact that under securities loans these risks and rewards always remain with the lender;[27] based on the "normal cause of events" this fact cannot speak against the transfer of tax/economic ownership at all. Also the standing case law, according to which the mere surrender of risks and rewards does not lead to a transfer or retention of tax/economic ownership in the securities, underpins this conclusion.[28]

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22 Cf. BFH, judgment dated 28 May 2015, IV R 3/13, BFH/NV 2015, p. 1577; judgment dated 9 January 2013, I R 33/11, BFHE 240, p. 226.

23 Cf. also marginal no. 21 of the Ruling, according to which the "*terms of the securities lending agreement entered into and the way of its implementation*" shall be relevant. See also *Desens*, DStR 2014, p. 2317, 2318.

24 This is because the obligation to manufactured/compensation payments does not restricted the entitlement to the income in a manner that is relevant for the tax/economic ownership because these obligations were independent from the possession/ownership in the securities as well as the receipt of the original payments, cf. Finance Court of the *Reich*, judgment dated 17 September 1931, RStBl. 1931, p. 868.

25 This is also acknowledged by the BFH, cf. judgment dated 16 April 2014, I R 2/12, BFHE 246, p. 15: *"As a general rule, the lender is, based on contract, entitled to a compensation payment in relation to dividends (so called compensation or manufactured payments) in the amount of the dividends that are paid on the equities during in the life time of the transaction"* and marginal no. 19 of the Ruling: *"The borrower receives the income on the securities he holds legal title in and he has to make a compensation payment in the same amount to the lender"*.

26 E.g., in cases of reverse stock loans, in the context of which the civil law owner of the equities receives a fee that (partly) comprises of the dividends.

27 Cf. also BFH, judgment dated 16 April 2014, I R 2/12, BFHE 246, p. 15: *"The fact that the borrower is obligated to retransfer to the lender fungible assets does not exclude the transfer of tax/economic ownership"* with further references (the underscore is not contained in the original). This retransfer liability always precludes the transfer of the risks and rewards from the securities to the borrower. See also *Rau,* DStR 2015, p. 2048, 2050.

28 Cf. BFH, judgment dated 11 July 2006, VIII R 32/04, BStBl. II 2007, p. 29, in relation to crossed options; judgment dated 16 April 2014, I R 2/12, BFHE 246, p. 15, in relation to total return swaps. Also the Ruling refers to the aforementioned judgment. See also *Mayer*, FR 2008, p. 139 et seqq.

- Disposal of securities: Pursuant to the Ruling, a criterion that points to a lack of tax/economic ownership of the borrower is that the borrower does not intend or does effectively not exercise his legal entitlement to dispose of the securities (e.g., due to a very short notice period regarding a termination).[29] Applying an *argumentum e contrario* there can be no doubt that the borrower is tax/economic owner in case he in fact on-sells, on-lends or otherwise disposes of the securities. In our view, also an effective term of securities lending transactions, may it only be for more than a few days, points to a transfer of tax/economic ownership.

In our view, it would have been preferable, if the BFH had discussed the significance of each of the above-mentioned elements and their respective weighing. Given that the court failed to do this, uncertainties remain in practice.

#### 2.4.3 Disguised abuse case?

Finally, the BFH referred to pre-tax negative yield of the transactions and draws the conclusion that the borrower's intention was only to acquire a formal position in the equities as to attain a tax sheltering effect. This rationale in relation to tax/economic ownership is unprecedented and in our view conceptionally not consistent either; to-date it has only been referred to as far as section 42 AO is concerned.

In this context the BFH has already regarded the existence of mere tax motivation, which can be evidenced by a pre-tax negative yield of a transaction, as a fact that points to abuse of tax law.[30] According to unofficial reports, certain judges at the relevant senate of the BFH were inclined to refer to section 42 AO in terms of the case at debate here. They have ultimately not been successful to impose their view. In our opinion, it would have been conceptionally more appropriate to choose this approach. Whether this criterion will continue to be considered in the future as far as tax/economic ownership is concerned, remains to be seen.

## 3. Summary

In our view, the Ruling does not constitute cause for a fundamental change of the taxation of securities lending transactions. Instead, the BFH has ruled in a singular case where declining the idea of the transfer of tax/economic ownership is based on the specific facts and circumstances. So, the Ruling presents itself as an exception.

Nevertheless, going forward the Ruling will have to be taken into account when designing securities lending transactions. Consequently, future structures should ensure that the borrower economically benefits from the income on the securities, that the borrower is from a factual perspective able to dispose of the securities (e.g., by agreeing on longer notice periods or terms) or even does dispose of them and that the transaction is pre-tax positive or justified by other *bona fide* reasons (e.g., liquidity benefits).

We will keep you posted on any new developments regarding the taxation of financial products and transactions as they occur.

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[29] This is a deviation from the older case law, see paragraph 2.3 above.

[30] Cf. BFH, judgment dated 12 July 2012, I R 23/11, BFHE 238, p. 344; judgment dated 27 July 1999, VIII R 36/98, BStBl. II 1999, p. 769.

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