New German Tax Rules to Reduce Cum/Cum Trades

by Volker Junge and Ingo Kleutgens

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On July 26 the German Investment Tax Reform Act (InvTRA) was published in the German Federal Gazette and, subject to some exceptions, came into force the following day. The InvTRA not only provides for fundamental reform of the tax rules for investment funds but also has provisions intended to stop some tax arbitrage trades between domestic and foreign market participants around the dividend record date (cum/cum transactions). Those transactions are used by foreign investors to avoid a definitive withholding tax burden by selling or lending German stock during the dividend season to German residents who are entitled to a withholding tax credit.

Because of its extensive scope, the new antiavoidance rule is likely to affect not only tax arbitrage trades but also many transactions that have a genuine business purpose and are not tax driven. Many taxpayers will therefore have to consider if and how they can avoid or reduce the increased costs resulting from the change in law. On July 15 the German Federal Ministry of Finance distributed a draft circular that addresses some of the many uncertainties arising under the new rule.

Background

Generally, German dividend withholding tax can be credited only against the German tax of domestic taxpayers, while foreign taxpayers eligible for standard treaty benefits are generally charged with a definitive German withholding tax of 15 percent. Under a cum/cum transaction, a foreign taxpayer usually lends its shares to a German financial institution shortly before the dividend record date, known as cum/cum transactions. A similar effect could be achieved with the help of repurchase (repo) transactions under which securities are sold and repurchased. Note, however, that cum/cum trades differ significantly from the widely disputed “cum/ex trades” that resulted in investigations against various market participants. In a cum/cum trade, a withholding tax refund is claimed only once, while cum/ex trades generally involved short sales with a withholding refund sometimes claimed multiple times (although the withholding tax was paid only once).

Far-Reaching Antiavoidance Rule

To prevent cum/cum trades, the InvTRA has introduced new Income Tax Act section 36a, a broad antiavoidance rule to limit the full withholding tax credit available to German domestic taxpayers. Broadly speaking, German taxpayers will be eligible only for...
full credit if they have sufficient economic entitlement to the relevant stock or equity-like profit participation certificates within a 45-day window around the due date of the capital income — usually the dividend-ex date.

German taxpayers who do not meet the tests described below will be entitled only to a credit of two-fifths of the withholding tax — that is, 10 percent if the withholding tax is 25 percent. The noncreditable portion (15 percent) corresponds with the tax treatment of ordinary nonresidents (who frequently benefit from a reduced 15 percent rate under a tax treaty).

The new antiavoidance rule generally applies to all German taxpayers, irrespective of whether any tax arbitrage transaction is intended or undertaken.

**ITA Section 36a**

ITA section 36a provides that withholding tax on German dividends or distributions on equity-like profit participation certificates is fully creditable only if the taxpayer:

- is the continuous economic owner of the stock or profit participation certificates during a minimum holding period (economic ownership test);
- continuously bears a minimum risk of a change in value during the minimum holding period (minimum risk test); and
- is not obliged to fully or predominantly compensate other persons directly or indirectly for the capital income (pass-through test).

If the taxpayer cannot prove he meets those requirements, three-fifths of the withholding tax is not creditable. The rule applies to German stock and profit participation certificates held with a German or non-German depository bank. An exception applies if the relevant capital income derived during an assessment period is not more than €20,000 or, at the time the income is derived, the taxpayer has held the economic ownership in the shares or profit participation certificates for at least one year without interruption. There is also an exception for some pension and unit-linked life insurance schemes.

The economic ownership test provides for a minimum holding requirement of 45 days that must be met within a period starting 45 days before and ending 45 days after the due date of the capital income. In the draft circular, the MOF says it will not object if taxpayers generally refer to the dividend-ex date for purposes of determining the minimum holding period. The uninterrupted economic ownership (and not the ownership under civil law) of the stock or profit participation certificates during that period is decisive.

For acquisitions and dispositions during that period, the first-in, first-out method has to be applied.

To meet the requirements of the minimum risk test, the taxpayer must continuously bear during the minimum holding period the risk of a decrease in value of at least 70 percent of the stock or profit participation certificates. In particular, the test is not met if the taxpayer has opposing claims — for example, because it enters into hedging transactions — that directly or indirectly reduce the risk of a decrease in value by more than 30 percent.

Macro-hedges and indirect hedges can be harmful. Even opposing claims of related parties must be taken into account. It is unclear whether any particular connection between related-party transactions and the taxpayer’s risk exposure is required; the draft circular does not indicate that a respective requirement exists. Further, the MOF imposes strict taxpayer obligations to provide supporting evidence regarding related-party transactions.

Taxpayers are usually expected to obtain a statement from a related party regarding whether and in what amount that party is entitled to opposing claims directly or indirectly via parties related to it (indirectly

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1ITA section 36a has retroactive effect on capital income received on or after January 1, 2016, the constitutionality of which is already being discussed.

2The solidarity surcharge remains fully creditable. The noncreditable withholding tax can be deducted only from the tax base (and only if applied for).

3If no German withholding tax is withheld, the taxpayer must notify the German tax authorities and pay the tax. The draft circular explains the particulars of that notification and clarifies that only the three-fifths noncreditable portion of the tax must be paid. The same applies if a taxpayer receives an unjustified withholding tax refund.

4The draft circular provides that this exception does not affect the determination of the minimum risk, which is debatable.

5According to the draft circular, the day the economic ownership is acquired and the day it is disposed of are not counted. For stock market transactions, which are settled in two days, the economic ownership is generally transferred on the day the sales contract is concluded. For over-the-counter trades, the economic ownership is generally transferred on the day the settlement takes place.

6According to the draft circular, it is sufficient that the opposing claims might increase in value if the value of the stock or profit participation certificates increases.

7The draft circular provides that the following instruments might result in opposing claims that reduce the risk of a decrease in value: options, swaps, futures, forwards, short sales, jouissance rights, investment fund units, and certificates. However, option rights that are embedded into listed or publicly distributed (reverse) convertibles are generally disregarded, according to the MOF.

8The MOF says the term “related” must be broadly defined and includes corporate, familial, contractual, or factual relations. However, a holder of a portfolio interest of less than 10 percent in an investment fund will not generally be considered a party related to the fund.
related parties). It is questionable whether the inclusion of indirectly related parties is in line with the law. The draft circular does not specify how a taxpayer can demonstrate that no opposing claims of related parties exist.

It is also unclear how to calculate the risk exposure (for example, in case of macro-hedges), and taxpayers will have to consider how they can demonstrate their calculations. The draft circular merely states that taxpayers must first determine if there is an economic relationship between the acquisition or holding of the shares or profit participation certificates and the opposing claims. If so, the opposing claims and the underlying transactions must be put into relation with each other. In the absence of an economic relationship, the hedging effect of all opposing claims on the entire portfolio of a share class must be taken into account.

A taxpayer fails the passthrough test if it is required, based on legal transactions, to directly or indirectly pass on to other persons more than 50 percent of the relevant capital income (for example, by way of compensation payments, lending fees, derivatives, repos, or swaps).

As with other antiavoidance measures around the world, it is expected that Germany’s new rule will result in uncertainty, complexity, and collateral damage that affects not only tax arbitrage trades but also numerous other stock-related transactions with a genuine business purpose that occur around the dividend record date. That could include, for instance, the refinancing or liquidity management involving securities lending or repos, so-called market making, hedging of stock-related derivatives, or employee stock option programs, as well as hedging transactions of financial institutions or insurance companies that are required under regulatory law.

**Future of the Capital Gains Exemption**

Notwithstanding its approval granted in the legislative procedure, the Federal Council emphasized that the new antiavoidance rule regarding cum/cum trades — particularly the minimum risk test — is unclear, impracticable, and not fully effective, saying it expects the German government to improve the new rule. Moreover, it suggested aligning the taxation of compensation payments under securities lending and repo transactions with the new rules on dividends.

Further, the Federal Council asked the government to abolish the capital gains exemption for portfolio shareholdings (a similar initiative had been proposed and rejected). A comprehensive repeal of the capital gains exemption for portfolio shareholdings could significantly affect private equity funds, start-ups, and business angels, but a more selective repeal of the exemption might conflict with German constitutional law and EU state aid rules.

**Audit Risks on Past Cum/Cum Trades**

Cum/cum trades undertaken before the enactment of the new antiavoidance rule are likely to be questioned by German tax authorities. Based on two recent Federal Fiscal Court decisions, tax authorities will likely examine whether the economic ownership of the stock was actually transferred to the German counterparty that claimed the withholding tax credit.12

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9The draft circular states that, in particular, corporations and specialized investment funds in which the related party holds a participation of at least 10 percent qualify as indirectly related parties that must be taken into account.

10For instance, for a micro-hedge covering a single underlying transaction, the draft circular says shares for which an identical number of put options is acquired must be disregarded for the minimum risk test. If a macro-hedge or portfolio hedge covers an entire group of underlying transactions or a particular inventory of shares, the opposing claims and underlying transactions/inventory must be put into relation with each other. Valuation units under German accounting or tax rules must also be viewed in combination for calculating the minimum risk. Apart from that, the MOF provides no further clarity on the calculation of risk exposure.

11While portfolio dividends are taxable, capital gains resulting from the sale of corporate shares, including portfolio shareholdings, are generally tax exempt in the hands of some German corporate investors.

12See Bundesfinanzhof, decisions of Apr. 16, 2014 (I R 2/12), and Aug. 18, 2015 (I R 88/13).