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Disposal of shares from a convertible bond issue

According to a ruling of the Supreme Tax Court published on 10 March 2022, where a financial company acquires a convertible bond with the intention of achieving a short-term proprietary trading profit and sells the shares received as a result of the conversion, this meets the conditions of Section 8b (7) sentence 2 Corporation Tax Act.

Facts

The plaintiff, a partnership under civil law (GbR), traded as a securities trading company and determined its profit by means of a surplus income statement pursuant to Section 4 (3) Income Tax Act (ITA) (in the version applicable in 2006).

In the year in dispute (2006), as in previous years, the plaintiff traded mainly in various securities and foreign exchange transactions via custodian banks and purchased gold bars. Furthermore, it generated trading income from its investment in A KG. At the beginning of the year in dispute, B, C and D each held 2% and E 94% in the plaintiff. Through a deed of gift from June 2006, E transferred his interest in the plaintiff to a foundation taking effect at the end of June 2006. The foundation was a family foundation with legal capacity based in Vaduz, Liechtenstein.

In the course of a tax audit, the tax office came to the conclusion that the transfer of the interest in the plaintiff by E to the foundation had resulted in a change of partner, so the loss carry-forward was to be reduced. The exercise of the conversion right was to be regarded as a transaction similar to an exchange/barter and the shares received were to be treated as trading income. In determining the capital gain within the meaning of Section 8b (2) CTA - insofar as the foundation held an interest in the plaintiff - the value of the shares (as acquisition costs) was to be set against the sales price achieved.

The action before the Munich Tax Court was unsuccessful.

Decision of the Supreme Tax Court

The Supreme Tax Court agreed with the decision of the lower court and rejected the appeal.

The Tax Court had correctly assumed that, following Section 8b (7) Sentence 2 CTA, Sections 8b (1) through (6) CTA do not apply to shares acquired by financial enterprises under the conditions set forth therein. Section 3 No. 40 Sentence 3 Half-Sentence 2 ITA contains an identical provision for the application of the so-called "half-income method".

The question at issue between the parties as to whether the factual requirements of Section 8b (7) Sentence 2 CTA and the parallel provision in the ITA had been met was answered in the affirmative by the Tax Court; this finding was correct at law.

The Tax Court was also correct when it agreed that it was not relevant - for the purposes of deciding whether the contested assessment was correct or not - whether the transfer of the shareholding by E to the foundation resulted in a partial change of partners. Also irrelevant was the question as to how exactly the exercise of the conversion right should be assessed for income tax purposes.

Source:

Supreme Tax Court, decision of November 13, 2021 (I R 37/18), published on March 10, 2022.

Keywords

banks, convertible bonds, financial company, proprietary trading profits