A Taxing Year for the Lending Industry

Ali Kazimi and Rose Li
Deloitte LLP

The following article was originally published in the Data Explorers Securities Lending Year Book 2009-10.

Taxation considerations have always loomed large in the securities lending industry. Indeed, the efficacy of securities lending transactions is often dependent on the right tax outcome. In 2009, there were a number of significant tax developments that are likely to shape the industry in years to come. We have set out below some of these developments as there are likely to continue to be important in 2010.

US Senate Hearing

The hearing entitled "Dividend Tax Abuse: How Offshore Entities Dodge Taxes on U.S. Stock Dividends" primarily focused on equity swap transactions that allegedly enabled investors to sidestep US dividend withholding taxes. During its investigation, the Subcommittee found that phrases like "dividend enhancement," "yield enhancement," and "dividend uplift" were being used to describe products which it regarded as abusive. It was also found that Notice 97-66 regulating foreign-to-foreign lending, despite it sourcing and characterisation rules, was proving ineffectual in preventing abusive transactions.

These developments have culminated in the tabling of proposed legislation referred to as FATCA, that seeks to revoke Notice 97-66 and introduce a more wide-ranging concept of a 'dividend equivalent' which includes the dividend income element embedded within derivative contracts as well as substitute (manufactured) payments arising under lending arrangements.

Global Master Securities Lending Agreement ('GMSLA') 2009

In July 2009, International Securities Lending Association (ISLA) published the 2009 version of GMSLA. The GMSLA 2009 updates the previous industry standard master agreement GMSLA 2000, with a number of important and significant tax enhancements. The tax related changes included:

- In general, greater clarity around tax terms and certain tax matters;
- manufactured dividends on lent securities to be agreed between the parties or otherwise to be equivalent to the gross amount paid by the issuer, assuming no withholding or deduction for tax;
- manufactured payments arising on non-cash collateral paid by the lender to the borrower to be equivalent to the amount that would have been received by the lender after any applicable withholding or deduction for tax;
- an updated UK tax addendum.

Notwithstanding the positive changes, the new GMSLA is unable to cover all relevant tax issues. It was never the intention for the document to provide for all possible tax matters. Indeed, whilst there is a UK tax addendum addressing UK tax issues, the agreement is silent in the case of other important jurisdictions such as the US.

Beneficial Ownership

The concept of beneficial ownership has been important in international tax law, and particularly so within the securities finance industry. The last 12 months has seen changes in the approach of tax authorities in their application of the concept of beneficial ownership.

For example, in Italy, new legislation introduced in April 2009 provided that dividends received by the borrower under securities lending arrangements would be essentially subject to the relevant tax implications applicable to the original lender, as if the securities had not been lent. However, such provisions have not been subject to any official explanation by the Italian tax authorities (as at the end of 2009) and therefore the practical application of the new regime and the documentation requirements to be met in order to transfer to the borrower the tax position of the lender are not entirely clear. In this regard, we are aware that participants in the Italian market (e.g. financial intermediaries acting as lending agents) are monitoring these types of transactions and exploring alternative solutions that may take the transactions out of the scope of the new provisions.

Another example would be the Swiss tax authorities, who have launched a general investigation in 2009 in connection with perceived dividend stripping transactions. The investigation saw numerous financial institutions (including UK banks) receiving information request letters from the authorities questioning the economic rationale of the transactions and also requesting details of the relevant counterparties involved (including residence). Specifically, Danish banks and financial institutions were first to be investigated since the Swiss-Denmark tax treaty allowed for a full withholding tax refund.

Similar information request letters were also seen from the Finnish tax administration, asking foreign investors detailed questions about their rights and entitlements under Finnish securities. We understand that a particular focus is placed on dividends flowing from Finland to UK, which is not surprising given London's role as the principal financial centre for the Nordic markets and the zero withholding tax for portfolio investors under the Finland-UK tax treaty.

The changing attitude of tax authorities and the recent actions taken together can be seen as, at least in part, a product of the recent International Fiscal Association round table and international discussion of the concept of beneficial ownership. Certainly, these global developments have also led to an increased awareness by the industry of the relevant tax issues surrounding securities lending transactions, particularly in a cross border context.

EU Discrimination Cases

A number of European Court of Justice cases have emerged in recent years which successfully challenged the withholding rules applied to dividend payments arising from various members states. The most recent case, the *Aberdeen* decision, is in line with the *Denkavit* and *Amurta* decisions which dealt with tax discrimination in regards to withholding taxes on outbound dividends. These cases have provided the basis for the reclaim of withholding taxes by investors on the grounds that rules applied by some member states result in a different treatment between domestic and overseas recipients of dividends.

The issue of whether and how the case law should apply for entities making claims to recover withholding taxes on manufactured payments on certain stocks (rather than actual dividends) raises fundamental questions around the impact on securities lending agreements, including the pricing of contracts. We would expect some of these issues to be further explored in 2010.

OECD Treaty Benefits and Collective Investment Vehicle

In December 2009, the OECD released its Report on the Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles. This update of the earlier January 2009 report, proposes changes to the commentary to the OECD model treaty dealing with the question of the extent to which collective investment schemes or their investors are entities to treaty benefits. One suggestion in the report is to apply an effectively transparent approach for the purposes of securing treaty benefits.

Whilst the report considers in detail the relevant technical issues, the practical issues of how a transparent approach would apply, particularly in securities lending arrangements, would need to be addressed. The report remains in draft form and consultation on the draft continues into 2010.

Conclusion

Overall, given the taxation developments impacting the industry, the major theme of tax derisking is likely to dominate 2010.

Contacts: **Deloitte LLP**

Ali Kazimi
Partner, Financial Services Tax
T: +44 (0) 20 7303 0144
E : akazimi@deloitte.co.uk

Gavin Kan
Manager, Finance Services Tax
T : +44 (0)20 7303 2692
E : gakan@deloitte.co.uk

Rose Li
Manager, Financial Services Tax
T: +44 (0) 20 7007 5338
E : roseli@deloitte.co.uk

Disclaimer