Securities Lending in Canada
Legal, Regulatory and Tax Issues

4th Annual CASLA Conference on Securities Lending

CASLA | Canadian Securities Lending Association

Securities Lending in Canada Legal, Regulatory & Tax Issues

- Christopher Steeves, Chair

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- Lesley Charkow

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Agenda

- CASLA Legal Subcommittee Initiatives
    - Lesley Charkow
- Canadian Tax Update
    - Christopher Steeves
- Recent U.S. Developments in Securities Lending
    - Michael McAuley & William Young
- EU Financial Transaction Tax Update
    - Michael McAuley & William Young

CASLA Legal Subcommittee Initiatives

- **CSA Proposed Amendments to Multilateral Instrument 62-104 *Take-Over Bids and Issuer Bids*, National Policy 62-203 *Take-Over Bids and Issuer Bids* and National Instrument 62-103 Early Warning System and Related Take-Over Bid and Insider Reporting Issues**
  - Aim to provide increased transparency of significant holdings of issuers' securities and enhanced disclosure of securities ownership positions
  - Proposed amendments would lower reporting threshold, add exemption for "Specified Securities Lending Arrangements" and require disclosure of the "material terms" of reportable securities lending arrangements
  - CASLA position:
    - Overall there is little evidence of "empty voting" in Canada
    - Lowering threshold may lead to "excess noise" in the market and important disclosures may be missed
    - Exemption should include borrowers that on-lend or transfer securities and do not exercise voting rights – focus on ultimate holder of securities
    - Not the proper venue to address general matters of transparency of SL arrangements
  - Comment period closed July 12, 2013; still under consideration by CSA

CASLA Legal Subcommittee Initiatives

- **Proposed Amendments to National Instrument 81-102 Mutual Funds Companion Policy 81-102CP Mutual Funds and Related Consequential Amendments and Other Matters Concerning National Instrument 81-104 Commodity Pools and Securities Lending, Repurchases and Reverse Repurchases by Investment Funds**
  - Changes intended to enhance the transparency of the benefits, costs and risks of securities lending and repo/reverse repo transactions engaged in by investment funds (mutual funds and closed-end funds)
  - Proposed additional disclosure relating to costs, revenue and returns in funds' offering and continuous disclosure documents if funds engage in these transactions, including public disclosure of contractual arrangements
  - CASLA position:
    - Current disclosure requirements are sufficient
    - Better to focus on educating investors on the general risks and returns than requiring prescriptive disclosure of specific contractual and financial information
    - SL contracts are commercial arrangements and public disclosure would not add value to investors
    - It is already standard practice for agent lenders to provide comprehensive and customized reporting to fund managers
    - Consider less prescriptive approach to disclosure similar to ESMA Guidelines for Exchange-Traded Funds which require general disclosure in the fund's prospectus and disclosure documents
  - Comment period closed August 23, 2013; still under consideration by CSA

CASLA Legal Subcommittee Initiatives

- **Annex 2 of the FSB document: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos**

  - Joint submission with CBA and IIAC
  - Proposed recommendations on minimum haircuts for non-centrally cleared securities financing transactions, including proposed numerical haircut floors
  - CASLA/CBA/IIAC position:
    - Framework of numerical haircut floors will apply to "non-centrally cleared securities financing transactions in which entities not subject to regulation of capital and liquidity/maturity transformation receive financing from regulated financial intermediaries against collateral other than government securities". Will banks and other entities interpret this consistently within and across jurisdictions?
    - Floors would have limited scope within broader SL and Repo markets and existing market practice often dictates haircuts above proposed levels. Will framework result in convergence to lower haircuts?
  - Submitted November 2013; still under consideration by FSB

CASLA Legal Subcommittee Initiatives

- **CSA Consultation Paper 54-401 Review of the Proxy Voting Infrastructure**
  - Assisted IIAC with their submission
  - Reiterated position that Canadian proxy voting system is not “broken” and does not need major regulatory or infrastructure overhaul
  - Issues better addressed by increased communication between participants
  - Past incidents of voting irregularities do not reflect Canadian system as a whole
  - Any changes should be made after cost-benefit analysis of effects on capital markets system as a whole
  - CASLA did not submit formal comments but will follow future developments

FATCA and IGA for the Enhanced Exchange of Tax Information

- On February 5, 2014, Canada and the U.S. finally signed an Intergovernmental Agreement (“IGA”) under the Canada-U.S. Tax Convention (the “Treaty”)

- One of the key concerns for Canadian financial institutions was the potential conflict with Canadian privacy laws

- IGA is very similar to the Reciprocal Model 1A Agreement with accompanying Annexes (I and II).

FATCA and IGA for the Enhanced Exchange of Tax Information

- Press release from Department of Finance (Canada) focused on the fact that Canadian financial institutions will not report any information directly to the IRS
- Information on accounts held by U.S. residents and U.S. citizens will be reported to the Canada Revenue Agency (CRA)
- CRA will provide this information to the IRS through existing provisions of the Treaty
- This mechanism is intended to ensure Canada’s privacy laws are not violated
- Information provided through the information exchange provisions of the Treaty are subject to safeguards regarding the use of the information
- IRS will provide enhanced and increased information about the accounts of Canadian residents held at U.S. financial institutions

FATCA and IGA for the Enhanced Exchange of Tax Information

- IGA provides exemptions and relief for Canadian financial institutions
  - Certain accounts are exempt from FATCA and will not be reportable including:
    - Registered retirement savings plans
    - Registered retirement income funds
    - Registered disability savings plans
    - Tax-free savings accounts
  - Smaller Canadian deposit-taking institutions (assets less than $175 million) will also be exempt

FATCA and IGA for the Enhanced Exchange of Tax Information

- The Department of Finance (Canada) also emphasized that the 30% withholding tax imposed by FATCA will not apply to clients of Canadian financial institutions and can only apply where a Canadian financial institution is in significant and long-term non-compliance with its obligations under the IGA

- Also, the FATCA recalcitrant account requirements that would oblige Canadian financial institutions to close accounts or refuse to offer services to clients in certain circumstances will be eliminated

FATCA and IGA for the Enhanced Exchange of Tax Information

- Draft legislation implementing the IGA provisions has been introduced and is currently going through Parliament
- Part of Bill C-31 which received second reading in the House of Commons on April 8, 2014 and has been referred to the Standing Committee on Finance

FATCA and IGA for the Enhanced Exchange of Tax Information

- Continuing controversy in Canada about the implementation of the IGA
  - Compliance with Canadian privacy laws?
  - Financial institution definition – personal trusts excluded?
  - Application of the Treaty to branches of non-Canadian financial institutions carrying on business in Canada?

- Some Canadian financial institutions are scrambling to register on the IRS FATCA registration website prior to July 1, 2014 and to have systems in place to collect necessary information

Technical Amendments to the ITA

- Technical amendments to the *Income Tax Act* (Canada) with effect retroactive to 2002.
  - Permitting certain non-arm's length loans
  - Addition of qualified trust units
    - Expansion to include foreign trusts effective Oct. 24, 2012
  - Changes to withholding tax on compensation payments to include qualified trust units
  - Rules governing partnerships

Fully Exempt Interest

- Technical Amendments also included change to definition of “fully exempt interest” for withholding tax purposes
- Compensation payments paid under a “fully collateralized” securities lending arrangement (“SLA”, as defined in section 260) that are deemed to be interest will be exempt from withholding tax in certain circumstances
  - Canadian resident borrower entered into the SLA in the course of carrying on a business <u>outside</u> of Canada (eg. foreign branch)
  - Underlying security is a bond, debenture, note or similar obligation issued by a non-resident of Canada (corporate or government)
- Particularly relevant where the underlying bond pays “participating debt interest” (e.g. gold-linked notes of foreign issuers)
- Retroactively effective to 2008

- Christopher Steeves

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Recent U.S. Developments in Securities Lending

- Michael McAuley & William Young

U.S. / Global Regulatory Update

- Basel Large Exposure Framework
- Basel Leverage Ratio and US Supplementary Leverage Ratio
- UCITs V

U.S. Tax Update

- FATCA – IRS Announcement 2014-33 – Delay in Enforcement of FATCA
- FATCA 2014 Regulations – Collateral Arrangements – Pre-2017 Transition Rule
- Final US Forms W-8BEN-E and W-8IMY – Cross-Border Securities Lending Aspects
- US Tax Code Section 871(m) – New Proposed Regulations – Equity-Linked Instruments – Withholding Tax 0n U.S. Dividend Equivalent Payments
- Collateral Securities Management under the ISLA Global Master Securities lending Agreement (2010) – Tax Ownership Issues
- IRS Notice 2010-46 – Update: "Qualified Securities Lenders" and "Credit Forward" System
- US 30% Withholding Tax on Borrow Fees / Negative Rebates Paid to Canadian Lenders – Who's Exempt; Who's Not?
- EU Financial Transaction Tax Update – Potential Impact on Cross-Border Securities Lending

FATCA – Notice 2014-33 (May 2, 2014)
IRS Announces Transition Relief for 2014 and 2015

FATCA – Notice 2014-33 (May 2, 2014)
IRS Announces Delay in Enforcement for 2014 and 2015

- Transition Relief. IRS eased enforcement for compliance with FATCA and other recent information reporting and withholding changes until 2016 for taxpayers making a good faith effort to comply with FATCA.
- Good Faith Effort. Entities will not be subject to withholding tax liabilities or penalties for failing to withhold in 2014 or 2015, provided they make a good faith effort over the next 18 months to comply with FATCA's requirements. Means that withholding agents and foreign financial institutions ("FFIs") must still implement FATCA in substance by July 1, 2014.
- "Pre-existing obligations". Accounts opened by entities throughout all of 2014 deemed to be "pre-existing accounts" for FATCA purposes, with the result that FATCA withholding will not apply to payments made to accounts opened prior to 2015 until, at the earliest January 1, 2015.
- Registration. No official extension on registration, but appears no FATCA withholding tax consequences for FFI if registered by December 31, 2014. Note: Model 1 FFIs do not have to register until December 31, 2014.

FATCA – Announcement 2014-17 (April 2, 2014)
IGA Agreements

FATCA – Announcement 2014-17 (April 2, 2014) Intergovernmental Agreements (IGAs)

- IRS Announcement provided that jurisdictions treated as having an IGA in effect would include those that, before July 1, 2014, have reached agreements in substance with the United States on the terms of an IGA and that have consented to be included on the Treasury and IRS lists of such jurisdictions, in addition to jurisdictions that have already signed IGAs.
- As of May 1, 2014, Treasury had signed 30 IGAs, and had agreements in substance with 29 jurisdictions. A complete list can be found on Treasury's website, available at http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.
- Canada entered into an IGA with the U.S. on February 5, 2014.

FATCA 2014 Regulations (T.D. 9657) (January 22, 2014) Collateral Arrangements Pre-2017 Transition Relief Rule

FATCA - 2014 Regulations Collateral Arrangements Pre-2017 Transition Rule

- Capital markets industry groups (e.g., SIFMA, ISDA) had requested relief from FATCA withholding on payments made under collateral arrangements.
- Comments indicated that general industry practice is to commingle collateral from all counterparties in a single account held by the secured party and that this practice does not permit the identification of collateral to a particular counterparty. As a result, a secured party is currently unable to determine whether it is acting as an intermediary or a principal with respect to some or all of the payments made to the counterparty based upon the secured party's right under a collateral arrangement to sell or loan the collateral to a third party.
- To allow the industry time to develop the systems necessary to make this determination, IRS temporary regulations issued January 22, 2014 added a transitional rule so that withholding on such payments will begin on January 1, 2017, provided that only a commercially reasonable amount of collateral is held by the secured party as part of the collateral arrangement.

FATCA 2014 Regulations Collateral Arrangements Pre-2017 Transition Rule

- **Reg. Sec. 1.1473-1T (vii). Collateral arrangements** prior to 2017 (transitional). A payment made prior to January 1, 2017, by a secured party with respect to collateral securing one or more transactions under a collateral arrangement, provided that only a commercially reasonable amount of collateral is held by the secured party as part of the collateral arrangement. For purposes of this paragraph (a)(4)(vii), the term transaction generally includes a debt instrument, a derivative financial instrument (including a notional principal contract, future, forward, and option), and **any securities lending transaction**, sale-repurchase transaction, margin loan, or substantially similar transaction that is subject to a collateral arrangement.
- Notice 2014-33 has no practical impact on the this proposed regulation.

IRS W-8 Forms
Where Are the Instructions?

Forms W-8BEN-E, EXP, IMY and ICI

- The entire FATCA Form W-8 series has been issued in final form. However, to date, only the instructions to Forms W-8BEN (individuals), W-8EXP (foreign governments and tax exempt organizations), and W-8ECI (income effectively connected with a US trade or business) have been issued. According to the Notice, the remaining instructions, including those to the W-8BEN-E (entities generally) and W-8IMY (intermediaries and flow-through entities), will be published "in the near future."
- Forms are challenging. Prior version of W-8BEN-E was 1 page; new form is 8 pages.

US Tax Code Section 871(m) – New Proposed Regulations – Equity-Linked Instruments – Withholding Tax on U.S. Dividend Equivalent Payments (Dec. 13, 2013)

Focus on U.S. Convertible Bonds

Dividend Equivalents – Section 871(m) Re-Proposed Regulations (4 Dec 2013)

- The 2013 proposed regulations apply to dividend equivalent payments made to foreign persons after 2015 on "specified" Notional Principal Contracts ("specified NPCs") (e.g., equity swaps) and "specified" Equity-Linked Instruments ("specified ELIs").
- An ELI is a financial transaction, other than a securities lending or sale-repurchase transaction or an NPC, that references the value of one or more underlying securities. For example, a futures contract, forward contract, option, debt instrument, or other contractual arrangement that references the value of one or more underlying securities is an ELI.
- **Importantly, the term ELI includes debt instruments convertible into underlying US equity securities.**

Dividend Equivalents – Section 871(m) Re-Proposed Regulations (4 Dec 2013) "Specified" NPC and ELI

- A "specified NPC" is any NPC that references an interest in an underlying security that pays US-source dividends and has a delta of .70 or greater with respect to the underlying security at the time the long party acquires the NPC.
- A "specified ELI" is any ELI acquired by the long party on or after March 5, 2014 that has a delta of .70 or greater with respect to an underlying US equity security at the time the long party acquires the ELI.

Dividend Equivalents – Section 871(m) Re-Proposed Regulations (4 Dec 2013) - U.S. Convertible Bonds (CBs)

- Working assumption - US CBs will have a delta above .70 and therefore CBs would be ELI and the interest payment would be viewed as a "dividend equivalent" for US withholding tax and reporting purposes under the 2013 proposed regulations.
- Assume that CBs received as collateral securities (outside of a pledge or security interest) from a non-US client after effective date will need to be substituted prior to any dividend entitlement date for the underlying stock after 2015 to avoid U.S. withholding tax obligations. Any failure to substitute timely will result in a U.S. withholding tax and reporting requirement.

Dividend Equivalents – Section 871(m) Re-Proposed Regulations (4 Dec 2013)
Convertible Bonds – Dividend Equivalent Amount

- A dividend payment on the underlying stock of a convertible bond would be treated as a "dividend equivalent payment" for purposes of section 871(m).
- The "long party" is the party entitled to the dividend equivalent.
- If the convertible bond is a specified ELI, US withholding tax would apply to dividend equivalent payments (the underlying dividends).

Dividend Equivalents – Section 871(m) Re-Proposed Regulations (4 Dec 2013)
Proposed Effective Dates

- As proposed, the new rules apply to payments made from January 1, 2016 on "specified" convertible bonds **acquired on or after March 5, 2014.**
- Responding to industry concerns, Notice 2014-14 (March 4, 2014) provides that 871(m) withholding will not apply to ELIs until 90 days after the proposed regulations are finalized.

Collateral Securities Management under the ISLA Global Master Securities lending Agreement (2010) – Tax Ownership Issues

Comparison: Master Securities lending Agreement (MSLA) versus Global Master Securities lending Agreement (GMSLA)

- MSLA – Used primarily in Canada and the U.S. Collateral securities "pledged" by borrower to lender. Lender has a security interest in collateral. Borrower retains tax ownership of collateral and any income generated thereon.
- GMSLA – Used in Europe and a growing number of other regions. Collateral securities transferred under "full transfer of title". Tax ownership of collateral and any income thereon shifts to lender.

Substitution of Collateral Securities Prior to Income Entitlement Event

- Under a GMSLA, common practice is substitute collateral prior to income entitlement event. Why?
- If no timely substitution, two tax transactions:
  (1) Receipt of collateral income by lender, and
  (2) Substitute payment from lender to borrower.

GMSLA (2010) – Consequences of Failure to Make Timely Substitution of Collateral Securities

- In general, if borrower fails to substitute timely, borrower suffers any tax detriment resulting from failure.
- Example: UK borrower provides U.S. equity shares as collateral to Canadian lender and fails to substitute. Lender receive dividend of 100 less 15% U.S. withholding tax. Lender must also withhold 15% from substitute payment to borrower. Lender pays borrower the dividend less withholding tax. Borrower receives less than normal entitlement of 85 and contractually suffers tax detriment.
- Query: What result if borrower is Canadian under a full transfer of title contract or a MSLA where lender has right to “use” (e.g., re-hypothecate) the collateral?

IRS Notice 2010-46 Update: “Qualified Securities Lenders” and “Credit Forward” System

Status of Notice 2010-46

- Notice 2010-46 has the force of U.S. regulations until expected regulations are issued.
- Transition rules under the Notice apply until regulations are issued.
- Per IRS/Treasury officials, the Notice 2010-46 regulatory project is not a high priority.

US 30% Withholding Tax on Borrow Fees / Negative Rebates Paid to Canadian Lenders – Who's Exempt; Who's Not?

Determination of Character of Securities Lending Payments

- First of all, except for substitute dividends, no regulations or other binding official guidance have been issued by the IRS regarding the taxation of securities lending payments.
- Section 1058 Proposed Regulations (1983) – substitute payment characterized as a “fee” paid by the borrower “for the temporary use of [the borrowed securities].” Although fees were not mentioned, the proposed regs provide some indirect support for classification as “rental income”.

Determination of Character of Securities Lending Payments (cont.)

- Under recent US income tax treaties (e.g., Japan, France), securities lending fees are treated as "other income" for treaty purposes.
- In a 1988 private ruling (8822061), which did not address character or source, securities lending fees received by an insurance company were classified as "industrial or Commercial Profits" for purposes of the applicable US tax treaty.
- Treasury "fails charges" – In Final Regulations (T.D. 9679) published February 21, 2012, source of income from a "qualified" fails charge is generally determined by reference to the residence of the income recipient. See Reg. § 1.863-10(a), effective December 8, 2010. In the preamble, the Government said "Treasury Department and the IRS are considering whether separate guidance is needed on the source of income attributable to certain payments, other than qualified fails charges, that arise in securities lending transactions or repurchase transactions and request comments regarding this issue."

Negative Rebates – Guidance needed from US Government on source of securities lending fees

- SIFMA and RMA (Securities Lending Division) have requested guidance,
- See SIFMA comment letter to U.S. Treasury dated August 1, 2012, an excellent analysis of the sourcing issue.
- RMA has also met with Treasury and generally supports the analysis and conclusions in the SIFMA letter.
- Issue is not on the current IRS priority guidance list.

Negative Rebates – Withholding Agent Unable to Determine Source at Time of Payment

- General US rule: Withholding required if withholding agent unable to determine if payment is subject to withholding because source of income not determinable at time of payment. Payment is treated as from US sources if the source cannot be determined at time of payment. [Reg. § 1.1441-2(a)]
- As a practical matter under such circumstances, a withholding agent must withhold 30% of the amount of the payment. [Reg. § 1.1441-3(d)(1)]

Negative Rebates – Policy Considerations – Competitive Disadvantage for US Borrowers

- Sourcing rule that imposes US withholding tax on lending fees paid to foreign lenders would place US borrowers at a disadvantage in competing with foreign borrowers for access to securities.
- Foreign lenders may be unwilling to lend securities to US borrowers without a tax "gross-up" agreement; would prefer non-US borrowers.
- UK – no WHT on borrow fees
- Canada – borrow fees treated as "deemed interest" which is not subject to WHT

Securities Lending Fees form US sources paid to Canadian lenders

- US withholding agents (securities lending borrowers and agent lenders) need to take a prudent approach from a US tax compliance perspective when paying borrow fees and negative rebates to Canadian lenders.
- US tax of 30% is required to be withheld unless a US domestic law or tax treaty exemption applies.

Available Exemptions

- Under US domestic sovereign tax immunity law (Code section 892), Canadian lenders that are eligible for exemption from US tax as a “foreign government” (e.g., certain provincial pension funds).
- US/Canada tax treaty: Article XXI, paragraph 1, Canadian lenders (charitable organizations), but not Article XXI, paragraphs 2 and 3, (pension funds and pooled funds with tax-exempt participants).
- Article VII (business profits exemption) – e.g., banks or insurance companies lending from balance sheet.
- Unfortunately, the “other income” article of the tax treaty is not effective, in that each country has the right to tax income from sources in its country.

Other Situations Where US Withholding Tax Is Not Required

- Canadian borrower is a “full-withholding” qualified intermediary and claims such status by providing a valid Form W-8IMY to the US withholding agent. Canadian intermediary is responsible for any required US withholding and reporting when it makes payments to its clients.
- Canadian borrower receives fees that are effectively connected with a business of the borrower in the US and provides a valid Form W-8ICI to US withholding agent.

EU Financial Transaction Tax
Enhanced Cooperation
Directive Dated 14 February 2013

Potential Impact on Capital Markets/ Securities Finance

EU Financial Transaction Tax Background up to May 8, 2013

- Sept 2011 – European Commission proposed EU financial transaction tax ("FTT") – fails to receive required assent of EU member States.
- Updated proposed Directive adopted on Feb 14, 2013 regarding EU FTT as it is to be implemented under "enhanced cooperation" for 11 member nations.
- The EC foresees implementation of this proposal in the 11 member states ("FTT Member States"; each an "FTT Member State") as early as 1 January 2014.
- The FTT Member States are: Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia.

EU Financial Transaction Tax Background Update since 8 May 2013

- April 30, 2014: European Court of Justice of the dismissed the U.K.'s challenge of a decision by the Council of the European Union authorizing 11 member states to establish enhanced cooperation to introduce a financial transactions tax. *United Kingdom v. Council* (C-209/13).
- Court: the two arguments put forward by the United Kingdom are directed at elements of a *potential* FTT and *not at the authorisation* to establish enhanced cooperation, and consequently those arguments must be rejected [as premature] and the action must be dismissed.

EU Financial Transaction Tax Update since 8 May 2013 (cont.)

- May 6, 2014. Joint Statement issued May 6 by ministers of Member States participating in enhanced cooperation in the area of financial transaction tax (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia and Spain)
- Commitment to the introduction of a financial transaction tax remains strong.
- Harmonized financial transaction tax is to be based on a progressive implementation of the tax with first focus on the taxation of shares and “some derivatives”.
- First step should be implemented at the latest on January 1, 2016.
- If individual Member States want to impose taxation for other products not included from beginning in scope of EU, FTT *they should be allowed to do so.*

EU Financial Transaction Tax
Global Reach

- EU FTT is far reaching and, if implemented as proposed, will have a significant effect on financial transaction businesses and clients worldwide, not just in the EU.
- FTT of not less than 0.1% would apply to certain securities lending and borrow, repo and reverse repo transactions, even if executed entirely outside the Member States.
- For example, a securities lending transaction that takes place through a lending agent in Canada or the U.S. would be subject to FTT if it involves one or more of the following factors: (1) loaned securities issued in any FTT Member State, (2) a lender that is a resident of any FTT Member State, or (3) a borrower that is “established” in any FTT Member State (including a US or Canadian branch of a financial institution established in any FTT Member State).

EU Financial Transaction Tax Scope - Financial Transactions

- Purchase/sale of securities and other financial instruments (including shares/units in collective investment funds)
  - Including all intra-group transfers
  - Repo and securities lending
  - On-market and “over the counter”
- Derivatives
- Material modifications- each “material modification” of a taxable financial transaction should be considered a new taxable financial transaction of the same type as the original transaction. Ex.: Stock loan reallocation.

EU Financial Transaction Tax
Certain Financial Transactions Excluded

Excluded transactions include:

- Primary market transactions:
  - Capital raising transactions (shares/bonds)
  - Issuance of government bonds
- Spot currency transactions
- Transactions by central banks and clearing houses (but, doesn't preclude taxation of a central bank's counterparty)

EU Financial Transaction Tax
Taxable Amount

- For <u>securities</u> and other financial instruments, greater of:
  - consideration paid or owed for the transfer, and
  - arm's length market price
- For <u>derivatives</u>: notional principal amount

EU Financial Transaction Tax
Tax Rate

- For securities and other financial instruments:
  - not less than 0.1 %
- For derivatives:
  - not less than 0.01 %

EU Financial Transaction Tax
Scope – Focus on Financial Institutions

- At least one party to transaction must be "established" in an FTT Member State ("FTT MS"), and
- A financial institution established in an FTT MS is a party to the transaction acting:
  - for its own account, or
  - for the account of another person, or
  - in the name of a party to the transaction
- As we shall see, the "established" principle is broader than it first appears.

EU Financial Transaction Tax Definition of "Financial Institution"

Definition is broad and includes (among other persons):

- banks, investment firms, insurance companies,
- investment firms, organized markets, credit institutions,
- collective investment undertakings and their managers,
- pension funds and their managers,
- special purpose entities,
- other undertakings,
- institutions, bodies or persons carrying out certain financial activities.

EU Financial Transaction Tax
Meaning of “Established”

- What does it mean to be “established” in an FTT MS?
- Notion of “establishment” is based on the "residence principle" supplemented by elements of the “issuance principle”, which was added to strengthen anti-relocation.

EU Financial Transaction Tax
Liability for payment of FTT

- For each transaction, FTT payable by each financial institution that is liable for FTT.
- FTT is payable to the tax authority of the FTT MS in the territory of which the financial institution is established or “deemed to be established”, on condition that this institution is party to the transaction, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction.
- Joint and several liability.

EU Financial Transaction Tax Parties Are FIs in Different FTT MS

- If two financial institutions, as parties to a financial transaction or acting in the name of parties to transaction, are established in different FTT MS, each such MS may charge FTT for the same transaction, at the rate each FTT MS has set.

EU Financial Transaction Tax
Cross-FTT Zone Transactions

- If one party to a financial transaction is located in the territory of a State which is <u>not</u> an FTT MS, the transaction is not subject to FTT in an FTT MS, unless the other party to the transaction is established in an FTT MS.
- In that case, the FI that is not established in an FTT MS will be <u>deemed</u> to be established in its counterparty's FTT MS and the transaction becomes taxable in the FTT MS.
- In other words, <u>each party to the transaction is deemed to be established in the FTT MS</u>.

EU Financial Transaction Tax
The "Residence Principle"

• An FI is deemed to be "established" in an FTT MS with respect to a securities lending transaction it conducts if FI:

- is authorized to conduct SL transactions in the MS
- is "passported" to conduct SL transactions in the MS
- is registered in the MS
- has a permanent address or usual residence in MS
- has a branch in the MS
- is a counterparty to a transaction in the MS
- is a foreign branch of MS (e.g., Montreal branch of French bank)

EU Financial Transaction Tax
The "Issuance Principle"

- The issuance principle applies even if none of the parties to the transaction would have been "established" in an FTT MS; parties are "deemed" to be established in an FTT MS if trading in financial instruments issued in that MS.
- Example: Loan of French shares from CDN lender to US borrower. Both lender and borrower are deemed to be "established" in France for FTT purposes.
- EC rationale: By complementing the residence principle with an issuance principle, it will be less advantageous for EU FIs to relocate activities and establishments outside the FTT jurisdictions, since trading in the financial instruments subject to taxation under the latter principle and issued in the FTT jurisdictions will be taxable anyway.

EU Financial Transaction Tax Established in a Participating MS

- *Article 4 (Establishment)*
- 1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
- (a) it has been **authorised** by the authorities of that MS to act as such, in respect of **transactions covered** by that authorisation;
- (b) it is **authorised or otherwise entitled to operate, from abroad, as financial institution** in regard to the territory of that Member State, in respect of **transactions covered** by such authorisation or entitlement;
- (c) it has its **registered seat** within that Member State;
- (d) its **permanent address or**, if no permanent address can be ascertained, its **usual residence** is located in that Member State;

(continued next slide)

EU Financial Transaction Tax Established in a Participating MS (cont.)

- (e) it has a **branch** within that Member State, in respect of transactions carried out by that branch;
- (f) it is **party**, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, **to a financial transaction with another financial institution established in that Member State pursuant to points (a), (b), (c), (d) or (e),** or with a party established in the territory of that Member State and which is not a financial institution;
- (g) it is **party**, acting either for its own account or for the account of another person, or is acting in the name of a party to the transaction, **to a financial transaction** in a structured product or one of the financial instruments referred to in Section C of Annex I of Directive 2004/39/EC **issued within the territory of that Member State**, with the exception of instruments referred to in points (4) to (10) of that Section which are not traded on an organised platform.

EU Financial Transaction Tax Meaning of “Authorised”?

- “1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
- (a) it has been **authorised** by the authorities of that MS to act as such, in respect of **transactions covered** by that authorisation;”
- Query: If a Canadian bank is “authorised” to engage in securities lending and repo transactions in an FTT MS, perhaps through its UK branch, is the bank *deemed* “established” in that MS with respect to all such transactions it conducts globally? Probably not the intent of Directive, but clarity needed.

EU Financial Transaction Tax
Effect of Passporting?

- “1. For the purposes of this Directive, a **financial institution shall be deemed to be established** in the territory of a participating Member State where **any** of the following conditions is fulfilled:
- (b) it is **authorised or otherwise entitled to operate, from abroad, as financial institution** in regard to the territory of that Member State, in respect of **transactions covered** by such authorisation or entitlement;”
- Query: If a Canadian FI establishes a separate banking entity in the UK, one that is “entitled to operate from abroad” (e.g., passported) to engage in securities lending and repo transactions in an FTT MS, is the UK entity *deemed to be* “established” in that MS with respect to all such transactions it conducts globally? Probably not intent.

EU Financial Transaction Tax Examples – Residence Principle

- **Example 1**: CDN Lender/US Agent/CDN Borrower/HK Loaned Shares.

No connection with an FTT MS. FTT does not apply.

- **Example 2**: Same as Example 1, except Agent is a US branch of a German bank.

FTT ought not to apply, but intent of Directive not clear.

Worse case result: Agent is deemed to be established in Germany under the “residence principle”, as it is operating through a foreign branch of a German bank, an FTT MS. Both the CDN lender and borrower are deemed to be established in Germany and are subject to EU FTT charges in Germany.

EU Financial Transaction Tax
More Examples - Reallocation

- **Example 3**: US Article XXI Lender/US Agent/CDN borrower/CDN Loaned Ordinary Shares.

No connection with an FTT MS. FTT does not apply.

- **Example 4**: Same as Example 3, except loan of CDN Ordinary Shares is reallocated to a French pension fund Lender.

The reallocation (substitution of counterparty) may be viewed as a "material modification" and a new loan under the Directive. If so, a reallocation to a French pension fund would mean that the CDN borrower is deemed to be established in France at the time of the reallocation and the borrower would be viewed as subject to EU FTT in France. [Borrower may be less than understanding if it becomes contractually liable for FTT under the terms of the Securities Lending Agreement with the US agent because Agent reallocated the loan to a lender in an FTT MS.]

EU Financial Transaction Tax Example – Multiple Lenders

- **Example 5**: Multiple Lenders (CDN 900 shares; France 100 shares)/UK Borrower/US Loaned Shares.

FTT applies to a portion of the loan to extent of shares on loan from the French Lender. For this portion (10%), UK borrower is deemed to be established in France. Canadian lender should not be subject to EU FTT.

Caveat: UK borrower <u>deemed to be established</u> in an FTT MS. See Art. 4, 1(a), (b); slides 19-22.

EU Financial Transaction Tax Example – Issuance Principle

- **Example 6**: CDN Lender/CDN Agent/CDN Borrower/Spanish Loaned Shares.

FTT applies. Loan of shares issued by a company in an FTT MS. CDN Lender, Agent and borrower each is deemed to be established in Spain. Because of this link, Lender and Borrower will have to pay EU FTT in Spain.

How is this FTT to be paid? Spanish custodian?

EU Financial Transaction Tax Example – Loan of ADR Shares

- **Example 7**: CDN Lender/CDN Agent/CDN Borrower/ADR (Belgium) Loaned Shares.

In the context of the "issuance principle" in the Directive, if the ADRs representing Belgian shares are "sufficiently linked" to an FTT MS (Belgium in this example) in which the issuer is located, the CDN Lender, Agent and Borrower will each be deemed to be established in Belgium. Because of this link, Lender and Borrower will have to pay EU FTT in Belgium.

How is this tax paid? ADR depository bank?

EU Financial Transaction Tax Example – Loan of ETF Shares

- **Example 8**: CDN Lender/CDN Agent/CDN Borrower/US ETF Loaned Shares (30% of assets in ETF consist of shares issued in FTT Member States).

Sufficient link to FTT MS? Does FTT apply to FMV of underlying assets of ETF in FTT MS at time of loan? TBD.

[Note: Under a proposed legislative amendment to the definition of a “qualified security”, a share of a US ETF should generally be classified as a “qualified security” and a loan of such a security by a Canadian resident will be a “securities lending arrangement” within the meaning of section 260(1).]