Application of DAC 6 to Financial Products and Services

June 2020

Executive summary[1]

1. The Association for Financial Markets in Europe (AFME) and the International Swaps and Derivatives Association (ISDA) represent leading global and European banks, and other significant participants in Europe's derivatives and wholesale financial markets. We aim to act as a bridge between market participants and policy makers across Europe, drawing on our strong and long-standing relationships, technical knowledge, and fact-based work.

2. EU Council Directive (EU) 2018/822 ("DAC 6" or "the Directive") is a tax reporting regime that requires arrangements to be disclosed where certain EU-defined hallmarks of potentially aggressive tax planning are met. Many of the hallmarks only require disclosure where, in addition to a hallmark, one of the main benefits of the transaction is the obtaining of a tax advantage.

3. There is presently a lack of guidance specifically addressing the application of the disclosure hallmarks to financial products. AFME and ISDA have therefore developed this paper to propose a common approach, based on market participants' understanding of DAC6 principles. The paper is being made publicly available to ensure that the analysis and conclusions are transparently disclosed to tax authorities, policymakers, market participants and their clients, and to foster dialogue among stakeholders.

Key principles

4. To facilitate a common understanding and application of the Directive, AFME and ISDA members have identified 5 key principles derived from the Directive, OECD commentary and initial guidance provided by several member states. AFME and ISDA members believe the following principles should be applied, by both taxpayers and tax authorities, when determining whether specific transactions or groups of transactions are subject to reporting.

Principle one: Reliance on Reasonable Procedures

5. Principle: financial institutions will have reasonable and proportionate procedures in place to identify and escalate reportable arrangements; where these procedures do not result in escalation, and the financial institution is acting in good faith, it will not have "reason to know" any unidentified arrangements are reportable.

6. Financial Institutions will leverage their existing tax risk governance frameworks to identify scenarios where they may be acting as an intermediary to a reportable, cross-border arrangement as defined under DAC 6. Financial Institutions recognise the policy intent of DAC 6

[1] THIS PAPER IS NOT INTENDED TO CONSTITUTE LEGAL OR PROFESSIONAL ADVICE AND DOES NOT PURPORT TO BE AND SHOULD NOT BE CONSIDERED A GUIDE TO OR AN EXPLANATION OF ALL RELEVANT ISSUES OR CONSIDERATIONS IN CONNECTION WITH EU COUNCIL DIRECTIVE (EU) 2018/822. MARKET PARTICIPANTS SHOULD EVALUATE THE INFORMATION CONTAINED IN THIS PAPER IN THE CONTEXT OF THEIR OWN SPECIFIC SITUATION AND REGULATORY OBLIGATIONS AND CONSULT WITH ANY LEGAL AND OTHER ADVISOR THEY MAY CONSIDER APPROPRIATE. AFME AND ISDA ASSUME NO RESPONSIBILITY FOR ANY USE TO WHICH ANY OF ITS DOCUMENTATION OR ANY DEFINITION OR PROVISION CONTAINED THEREIN MAY BE PUT.

and will, in good faith, enhance existing tax risk-based policies and procedures, where required, to ensure they comply with any DAC 6 reporting obligations that arise.

7. We understand that the directive does not intend to introduce additional tax due diligence obligations on intermediaries. Therefore, it is reasonable for Financial Institutions to use proportionate, risk-based escalation and evaluation procedures. It would be expected that a Financial Institution's existing tax risk governance framework, and by extension its processes for DAC 6, is customised to take into account higher and lower risk products and services.

8. Where these tax risk controls are not triggered, or do not result in escalation, it would be reasonable for Financial Institutions to conclude that they did not know or have reason to know that they are acting as a service provider for a reportable arrangement and, accordingly, that they will have no reporting obligation under DAC 6.

Principle two: Limited Knowledge acquired in the Ordinary Course of Business

9. Principle: Financial institutions engaged in ordinary course transactions and services, routinely performed in connection with non-tax related activities, are unlikely to have "reason to know" that a third party has engaged in those transactions as part of a reportable arrangement.

10. The directive defines a "Service Provider" intermediary as someone who provides "aid, assistance or advice" and knows or could reasonably be expected to know they have provided that aid, assistance or advice in respect of a reportable arrangement. As stated above, we understand that the directive does not intend to introduce additional tax due diligence obligations on intermediaries; a Financial Institution would determine whether they have a reporting obligation based on available information after performing ordinary due diligence activities expected for the product in question.

11. The provision of ordinary financial products and services is unlikely to give Financial Institutions reason to know they are providing services in respect of a wider, reportable, cross-border arrangement implemented by a client. Ordinary financial products and services are typically vast in volume and used for genuine commercial purposes.

12. Where a Financial Institution specifically designs or markets a product for tax reasons or tailors a transaction based on tax attributes relevant to the client or Financial Institution, it can be expected that the Financial Institution would have knowledge of the arrangement as a whole and should consider the application of the hallmarks.

Principle three: Policy Contravention Requirement

13. Principle: The main benefit test is only met if a tax advantage is contrary to policy.

14. A tax advantage that is derived due to the proper operation of law and policy, including consideration of the intent of the law, should not be reportable as aggressive tax planning. Conversely, an arrangement will meet the main benefit test if a Financial Institution concludes that the tax benefit is inconsistent with law and policy. Where it is not immediately apparent whether a tax advantage is consistent with law and policy, a Financial Institution will take further steps to review as appropriate.

15. The preamble to the Directive makes it clear that the purpose of the legislation is to ensure tax authorities are informed of potentially aggressive tax arrangements. Where an arrangement produces a tax advantage that is consistent with the law and policy, it should not be regarded as either aggressive or beyond the knowledge of the tax authorities. This principle is echoed in supplementary material published by some jurisdictions. For example, the Explanatory Note to the regulation issued by the UK authorities explains that a "tax advantage" only arises where a reduction in tax cannot reasonably be regarded as consistent with the principles and policy objectives of the tax provisions that are relevant to the arrangement in question.

Principle four: Revenue Loss Requirement

16. Principle: In order for a tax advantage to exist, an arrangement must be reasonably expected to result in a reduction in the absolute amount (or present value) of tax collected by a relevant authority.

17. A tax advantage, by definition, should only arise if an arrangement results directly or indirectly in an identifiable and unjustifiable shortfall in the amount of tax payable to a tax authority. Financial Institutions will interpret this principle in good faith, and broadly, to include scenarios where an arrangement erodes the tax base of a jurisdiction or artificially circumvents a requirement to withhold or account for tax.

18. The preamble to the Directive makes it clear that the objective of the regime is to assist EU Member States in protecting their national tax bases. Accordingly, we understand that the determination of whether a tax advantage is expected to arise must take into account the expected impact of an arrangement, as a whole, on the taxes that a particular tax authority expects to receive. If there is no reasonable expectation that an arrangement will result in less tax being collected, that arrangement should not meet the main benefit test.

Principle five: Relative Materiality

19. Principle: A tax advantage is only one of the main benefits of an arrangement if it represents a significant portion of the total expected benefit of the arrangement.

20. Although efficient tax planning may be an intrinsic part of certain financial transactions and products, it would usually be expected that tax is simply an ancillary or contributory consideration. There are many examples of products where tax may form part of the overall pricing of a financial product – this fact alone should not be sufficient to meet the main benefit test. Where non-tax benefits are expected to substantially outweigh tax benefits, the main benefit test should not be satisfied. On the other hand, where the tax benefit derived from a transaction is known to be significant compared to any commercial benefit, that arrangement would warrant further scrutiny.

21. We understand the use of the word "main" is not intended to mean that tax is the single greatest or only benefit of a transaction. However, we also understand that it must be a substantial benefit relative to all of the benefits that could be anticipated from an arrangement.

Application of the Principles to financial products

22. The application of the five preceding principles to financial products can be summarised as follows: Financial Institutions have tax risk governance frameworks that act as a filter to ensure

noteworthy transactions are escalated to and reviewed by their tax functions; these tax functions will then consider whether a reporting obligation has been triggered, including – where relevant – whether the main benefit of an arrangement is a tax advantage and, if so, whether that advantage is inconsistent with existing law and policy.

23. The following examples demonstrate how the principles might apply to some common financial products.

Securities lending

24. Below is a concise application of the Principles to securities lending. For further details concerning securities lending please see Appendix A, where we have provided an explanation of the product and further analysis concerning the application of DAC 6 to securities lending transactions.

Non-reportable scenario

25. Financial institutions act as agent lenders to facilitate the lending of securities from a lender to a borrower. Alternatively, securities dealers may also borrow and on-lend to their own clients or borrow for their own purposes (e.g. to cover a short position). As set out in Principle two, in the ordinary course of business, financial institutions carrying out such borrowing or lending activities are unlikely to meet the definition of Intermediary as defined under DAC 6. This is because, typically, once securities are lent they will then be sold or on-lent to third parties for genuine commercial purposes – therefore, neither the agent lender nor the securities dealer is likely to have reason to know details concerning the tax position of the ultimate purchasers of the securities. In fact, the identity of the ultimate purchasers will be unknown in many instances.

26. Principle four is also relevant in this scenario. Where securities are borrowed and sold short in the market, in the absence of specific knowledge to the contrary, there is no reasonable expectation that an arm's length purchaser will pay any less tax than the lender would have paid and therefore the main benefit test is not implicated.

Potentially reportable scenario

27. In the alternative, where a financial institution enters into a securities lending arrangement that is specifically tailored to the tax attributes of the parties to the agreement so that a tax benefit may be gained; and the parties specifically agree that the tax benefits will be shared amongst the participants, including the financial institution; then the arrangement should be subject to further scrutiny.

28. In such a case, the review by a tax function should include consideration of whether the main benefit test is met, bearing in mind the tax laws of the relevant jurisdictions. Crucially, this conclusion is drawn because the financial institution, via their participation in the lending transaction, has knowledge concerning the structure of the arrangement and is able to weigh the materiality of the tax advantage that will be derived with other benefits. Where, upon review, it becomes clear that the main benefit test is met and the arrangement meets one of the DAC 6 hallmarks, for example A2, that arrangement would be reportable.

Derivatives

29. Below is a concise application of the Principles to derivatives. Derivatives, including specific examples of futures and swaps, are explained in further detail in Appendix A. As with securities lending, Appendix A also includes further analysis of the application of DAC 6 to derivatives contracts.

Non-reportable scenario

30. Futures are a common derivative contract and an investment in a "vanilla", listed future is unlikely to give rise to a reporting obligation under DAC 6 as it is unlikely to meet any of the hallmarks. Furthermore, although tax may be one of many factors an investor takes into account when deciding how to invest their capital, the tax advantages a future may offer over other forms of investment would, ordinarily, be relatively minor compared to commercial gains made through the potential increase in value of the future contract or asset(s) referenced by the future contract.

31. Accordingly, we believe Principles one, three and five are relevant.
    a. Principle five is applicable because any tax advantage associated with the arrangement is merely incidental relative to the hoped-for non-tax benefits. Tax cannot, therefore, be said to be a main benefit of the arrangement. The conclusion may be different if there are other, known components to the arrangement that increase the relative value of the tax advantage.
    b. Principle three is applicable as the taxation of futures contracts is a matter of well settled law in most jurisdictions and therefore the mere purchase of a future should not be seen as contrary to articulated tax policy.
    c. Principle one can be illustrated by this example as well. Millions of listed futures contracts are traded every day, and they are routinely used without consideration of potential tax advantages – they are not infrequently used by institutions that are exempt from all taxes. On this basis, we would not expect that reasonable and proportionate identification and escalation procedures would require heightened monitoring in connection with the purchase of vanilla, listed futures.

32. The above principles can also be applied to other, common derivatives, such as options and swaps which allow investors to obtain hedge their exposure, benefit from price volatility or leverage their investment.

Potentially reportable scenario

33. Where a client enters into swaps with a securities dealer and states that one of the objectives of the trade is to achieve a particular tax outcome, it would be reasonable to expect that the trade would be escalated to a tax function for review both for general tax risk management and for DAC 6 reasons. Upon review, if it becomes clear that the tax benefits are significant compared to other benefits – and the tax advantage gained is not consistent with law and policy – and the arrangement meets one of the DAC 6 hallmarks, that arrangement would be reportable. For completeness, if it was discovered that the arrangement met a hallmark that does not also require the main benefit test to be met, the arrangement would be reportable even if a tax advantage was not a main benefit. Here, Principle five may not apply because of the suggestion that the tax advantage is material.

Appendix A: Derivatives, securities lending and borrowing, sale and repurchase agreements and collateral transfers

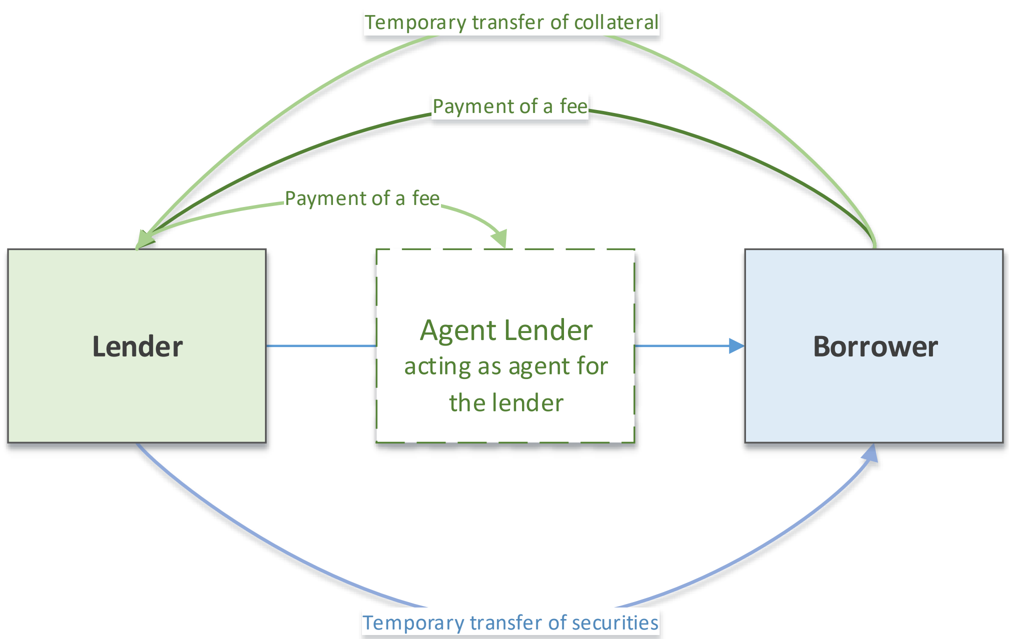
Overview of securities lending, derivatives and similar products

34. Financial institutions (e.g. banks, brokers and custodians) provide a range of services to clients who wish to trade in securities or who wish to get exposure to securities via other financial products. Such services include, but are not limited to:
    a. Entering into or arranging securities lending transactions. The financial institution may facilitate lending between two unrelated counterparties as agent or may act as a borrower or lender of equities as principal.
    b. Writing derivatives such as swaps and contracts for difference which will typically include payments which are calculated with reference to the performance of an underlying stock or basket of stocks and a financing element. Other derivatives include futures and options which provide a client with the ability to buy or sell a stock in the future at a pre-agreed price.
    c. Sale and repurchase agreements or "repos", which can be described as loans secured by the transfer of securities, are not discussed in detail in this paper; however, we consider that the principles and conclusions that will be put forth concerning the application of DAC 6 to securities lending apply equally to repos.
    d. Similarly, collateral arrangements are not analysed in detail; however, we consider the principles below apply equally to collateral arrangements.

Securities lending

What is securities lending?

35. Securities lending is the lending of securities, including the transfer of legal title, by a lender to a borrower for either a specified period of time or on an open basis whereby the lent assets are recallable at any time by the lender or its agent and returnable at any time by the borrower.



36. Financial Institutions may act as agent lenders and facilitate the lending of securities to borrowers. Lenders tend to be large, institutional investors (e.g. mutual funds, pension funds, insurance companies and sovereign wealth funds) and borrowers tend to be broker-dealers borrowing for their own purposes (including those listed in paragraph 40) or to on-lend to their underlying clients; agent lenders are usually custodian banks.

37. Securities lending is a common financial service, which plays an important role in the efficient running of financial markets. According to the International Securities Lending Association, the total, global value of on-loan securities exceeds two trillion USD. At a market level, securities lending facilitates market-making activities of financial institutions, enables short selling, increases liquidity and helps mitigate price volatility.

38. The principles outlined below are considered to apply equally to repos, collateral transfers and other, non-securities lending arrangements that result in the temporary transfer of securities from one party to another.

Does the FI have reason to know that a transaction meets the hallmarks?

39. Financial institutions play an important intermediary function as they will match lenders and borrowers for specific securities; however, that role would not ordinarily extend to structuring arrangements for tax purposes. Financial Institutions will often understand the broad, commercial rationale behind securities lending transactions and may have an awareness of the general tax framework and consequences for market participants. However, in the absence of specific knowledge, it is unlikely a Financial Institution will know why a particular borrower is entering into a particular securities lending transaction and whether that transaction is tax motivated. Borrowers and lenders will enter into securities lending arrangements for a broad range of commercial reasons, as outlined below.

40. Borrowers borrow stock for a variety of reasons, including:
    a. to sell the stock short[2] if they believe they can generate profit from downward price movements;
    b. to sell short for hedging purposes (i.e. to hedge an existing long position);
    c. to on-lend to a client or counterparty which is selling short; or
    d. to cover failed trades to ensure the efficiency of settlement infrastructure and preventing systemic risk.

41. In many instances, securities dealers who borrow securities would on-lend those securities to a client or sell to the market.

42. Similarly, lenders lend their stock out for a number of commercial reasons, including:
    a. to earn stock lending fee income either:
        i. in their capacity as a market maker;
        ii. borrowing and on-lending stock as principal; or
        iii. to monetise their portfolio;
    b. to obtain financing for their securities; or

[2] It is noted that when reference is made to “selling short”, this ordinarily involves borrowing in securities to settle a short sale. This can be achieved because the settlement cycle, the time required for delivery of the security, is typically shorter for a securities loan than for a sale of securities.

c. collateral upgrades, whereby lenders lend out their stock in return for high quality securities as collateral.

43. If a Financial Institution has specific knowledge concerning the tax planning of the parties to the transaction or designs or promotes a trade based on the tax attributes of the parties to the transaction, then it could be expected to have reason to know the arrangement is reportable and would be required to properly assess whether a reporting obligation arises.

Does the ‘main benefit’ test apply?

44. For the reasons set out in the paragraphs below, where none of the parties to a securities loan has any specific knowledge or a reason to believe that the pricing of an arrangement is linked to a tax advantage obtained by a taxpayer, there should be no basis to infer that a tax advantage is a main benefit of the arrangement. In particular, the following paragraphs will examine the pricing of a securities lending arrangement that takes into account the payment of a dividend or coupon.

45. It is also noted that, although real dividends paid in relation to equities or coupons paid on bonds are more likely to be subject to withholding tax than income flows on securities loans, this ultimately depends on the jurisdiction of the underlying stock issuer and other relevant tax attributes relating to the parties of the transaction. For example, the US imposes withholding tax on dividend equivalent payments and the French and Germans impose withholding tax on manufactured payments in certain defined cases.

Pricing a securities lending arrangement

46. A number of factors contribute to the pricing of a securities loan. These include the level of demand and supply for a particular security, the type of collateral a lender will accept, the credit worthiness of a borrower, the flexibility of the contractual requirements, operational efficiency and the target profitability of the short sale undertaken by the borrower. The price paid by the borrower comprises two amounts: the fee and the substitute dividend, the latter being relevant when the loan crosses a dividend date. Combining these two elements, the price paid for lending over dividend date is commonly referred to as the “all-in” rate or fee.

47. One other, contributing factor to pricing, where a securities loan crosses dividend date, is the withholding tax rate a jurisdiction applies to the payment of a dividend. Withholding tax rates levied by a jurisdiction may vary depending on the type of beneficial owner receiving the dividend and their tax residence. The price a borrower is willing to pay to borrow the stock and the price a lender is willing to accept may be affected by those specific and sometimes variable values.

48. The factors influencing pricing are aggregated across market participants, resulting in a market-determined, all-in rate that is quoted by a lender or the lender’s agent to all prospective borrowers. Individual borrowers will pay that market-quoted price regardless of their own specific positions (e.g. internal financing rates or reason for the borrow) or tax status. It is noted that the price may rise or fall depending on market conditions.

49. One of the common reasons market participants enter into a securities loan is to cover a short sale. When securities are borrowed to cover a short sale, the borrower will not hold those securities as they will be delivered to a third party purchaser under that short sale. Given the securities are sold, the amount that a borrower will be able to pay as a substitute dividend is not driven by the receipt of an actual dividend by that borrower.

Derivatives

50. Derivatives offer investors the ability to gain or hedge exposure to the economic performance of an asset without directly purchasing that asset. Like securities loans, where a derivative contract crosses a dividend or coupon payment, that dividend or coupon amount will usually be factored into the price or payments under the derivative. Further, investing in a derivative may result in different commercial and tax outcomes compared to other hypothetical transactions. This is relevant to a number of derivative contracts, but, for simplicity, we will consider futures and swaps in the following section. It is noted that derivatives come in many permutations.

Futures

51. Futures are standardised derivatives contracts that allow buyers and sellers to agree to transact in an underlying asset at a pre-determined price at some future date; they are listed and traded on futures exchanges.

52. To illustrate how futures work, imagine an investor would like to gain exposure to the performance of European equity markets via the Euro Stoxx 50 total return index. To implement this decision, the investor could adopt a number of approaches, including:
    a. buying the individual shares represented in the index;
    b. investing in a fund that references the performance of that index;
    c. purchasing a structured note linked to the index;
    d. entering into a bilateral derivative agreement referencing the index; or
    e. transact in a listed derivative, such as a futures contract, referencing the index.

53. A rational, well informed investor would weigh the pros and cons of the investment opportunities available to them, bearing in mind their own capacity to enter into any of those opportunities. The investor could decide that a futures contract would be relatively more commercially and tax efficient than some of the other available alternatives. From a commercial perspective:
    a. purchasing all of the securities that comprise the Euro Stoxx 50 total return index would be:
        i. more burdensome;
        ii. require more upfront capital – futures would allow an investor to leverage their capital; and
        iii. incur “carry” costs associated with custody accounts.
    b. the investor may not have sufficient expertise or capital to enter into a derivative agreement with a securities dealer or purchase a structured product.
    c. further, the futures contract itself may be a tradeable security and, depending on the initial pricing of the contract and market volatility, the investor may profit from the purchase and sale of the futures contract itself, making it a potentially more commercially attractive option than purchasing units in a fund.

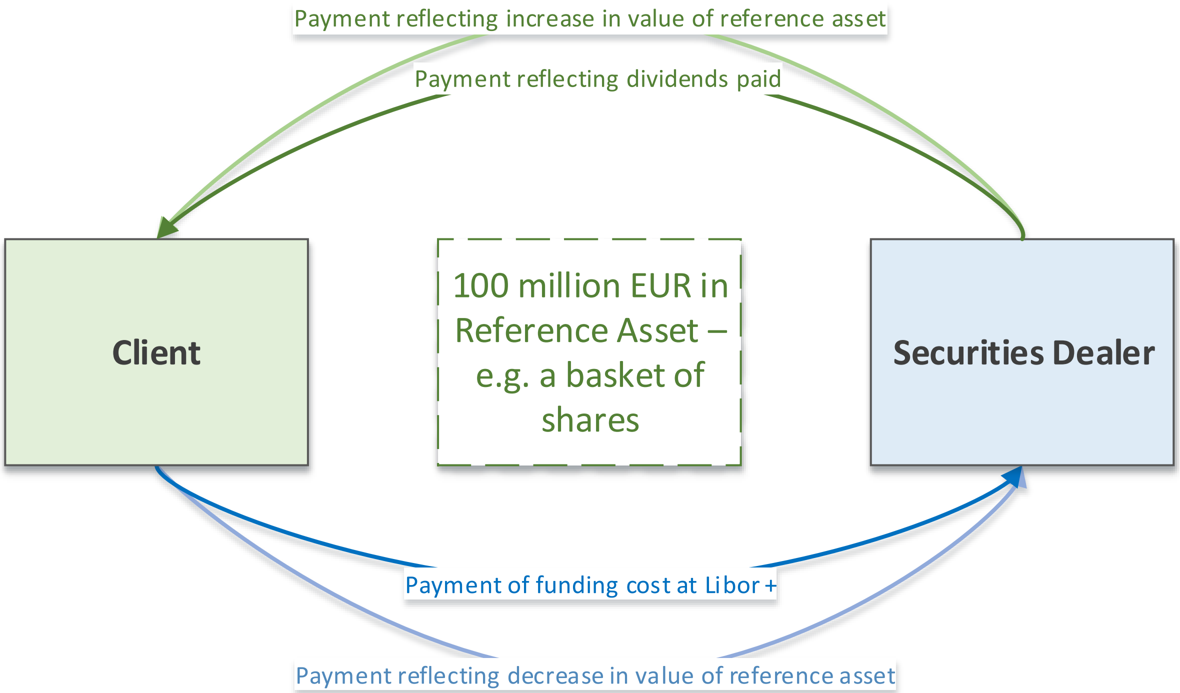
54. A futures contract may be subject to different taxation when compared to the purchase of the individual securities, especially when considering transaction taxes and the taxation of gains or losses on individual securities. It is important, however, to recognise that the differences in tax outcome would normally be sub-ordinate to the commercial outcome. Fundamentally, if an investor wishes to purchase a future referencing a total return index, on day one that decision is likely to be driven by an expectation that the growth in value of the index or the futures contract

will yield a commercial return. Any tax benefits, though a relevant consideration, are likely to be ancillary or incidental and are dependent on the actual return.

55. Investment into different financial instruments gives rise to different tax outcomes under tax laws – as well as different commercial outcomes. AFME and ISDA do not believe the mere fact that different financial instruments might offer different tax outcomes automatically satisfies the main benefit test, and nor would such an approach facilitate the objectives of the DAC 6 regime. The application of the main benefit test is discussed in further detail after the next section.

Swaps, including total return swaps

56. Where a derivative contract crosses a dividend or coupon payment, that dividend or coupon amount will usually be factored into the price or payments under the derivative. This is relevant to a number of derivative contracts, some of which are outlined in the overview section of this paper; however, for simplicity, an equity swap can be used to illustrate the point. For completeness, it is noted that we believe the principles outlined below may also be applied to other derivatives and derivative-like products, including futures, options and note issuances referencing underlying assets.



57. Two parties agree to an equity swap for an agreed notional principal amount – e.g. 100 million EUR. Importantly, under an unfunded swap, the agreed principal is notional; the client does not “fund” the swap by providing 100 million EUR at inception. Swaps can be customised, but the above is a common example where, at maturity, one party will receive the increase in value of a basket of shares (e.g. shares in German car manufacturers; referred to as the “reference asset”) multiplied by the principal and a payment calculated with reference to the dividends paid on the reference asset(s). The other party will receive any decrease in the value of the reference asset multiplied by the principal and a financing payment (e.g. principal multiplied by LIBOR[3] + 0.25%).

[3] Or any benchmark rate, including successors to LIBOR

The reference asset of a swap could be a basket of securities, but it could also be as broad as an index or as narrow as a single security.

58. There are a variety of reasons why a client may wish to gain economic exposure to an asset via a derivative contract rather than by purchasing the underlying asset directly. For example, using the above example:
    a. the costs of purchasing the securities would be higher – i.e. you need more capital to purchase the assets directly;
    b. holding the securities would require a custodial and administrative set-up, and incur relevant costs;
    c. it would be more administratively burdensome to purchase every security that forms part of a referenced basket of shares;
    d. some clients may be commercially restricted from purchasing the underlying assets;
    e. derivative contracts may form part of a client's general investment strategy and allowing them to more effectively manage either a single stock or portfolio risk; and
    f. derivative contracts allow an investor to manage forex exposure when trading multiple currencies on baskets of stocks as the contract itself may be denominated in a currency of choice.

59. As discussed in the preceding section concerning futures, a client entering into a swap may not be subject to withholding tax on the payments under the derivative contract and this may have been different had they bought the underlying assets. E.g. in the example above, had the client bought all of the German car manufacturing companies' shares they may have been subject to withholding taxes on dividend payments. Further, where a client purchases reference assets directly, the client may also be subject to other taxes such as stamp duty, financial transactions tax and non-resident capital gains tax or benefit from certain tax advantages related to the receipt of actual dividends.

Does the FI have reason to know that a transaction meets the hallmarks?

60. There are important commercial drivers which will influence the client's choice of investment. Derivatives transactions are very high volume and, in most cases, a Financial Institution is unlikely to be aware of all the facts, or the specific motivation of the client – particularly given clients will likely have a broad portfolio of financial instruments.

61. Where a client requests a bespoke arrangement or a client's request is atypical or off-market in terms of pricing or structuring, it would be expected that a financial institution's internal governance processes would require review by relevant subject matter experts, including Tax, and a DAC 6 reporting obligation may be identified. It is important to note that Financial Institutions are not tax advisors and would not normally review or audit a counterparty's tax position nor would they have access to information concerning a client's tax planning.

Does the 'main benefit' test apply?

62. We do not believe that it would be appropriate to infer that one of the main benefits of a derivatives contract is a tax advantage solely because a transaction does not attract the same taxes in comparison to another 'hypothetical' transaction. Given tax costs may differ depending on the type of financial instrument purchased, tax considerations may be one of many relevant factors for an investor when deciding how they will invest their capital. What ultimately lies before an investor is a number of different choices, each with their own legal, commercial and –

sometimes – tax consequences. Further, it is our understanding that tax authorities are aware that different financial instruments attract (or don't attract) different types of taxes.

63. We would note that if a jurisdiction sought to impose withholding tax on manufactured dividends and the parties to a transaction deliberately structured the arrangement to circumvent the rules, by using specific instruments or entities, then the arrangement should be subject to further review and, where relevant, reporting by those parties.

64. In the ordinary course of business it would be normal on day one to expect that tax will be a subordinate consideration to the commercial benefit or return from a derivative contract. AFME and ISDA members would not expect the terms of a derivative contract alone would allow them to conclude that the main benefit of an arrangement, for the counterparty, is tax – unless they had specific knowledge concerning the counterparty or their tax affairs.

Application of specific hallmarks to securities lending and derivatives

65. Although we are of the view securities lending and derivatives transactions would not ordinarily meet the main benefit test nor give rise to a reason to know, below we consider the DAC 6 hallmarks that may be most relevant to these products and when they may or may not apply. We would not expect the other hallmarks to be relevant to these products.

Hallmark A2 – Remuneration fixed by reference to tax

66. It is our view that in the ordinary course of securities lending neither the all-in fee paid by a borrower nor the fee earned by an agent lender or lender is fixed by reference to a tax advantage gained from the securities loan, nor is it dependent on tax benefits being achieved by any of the parties to the securities loan or arrangement.

67. As discussed under the main benefit test sections above, the fee paid on most securities lending transactions is driven primarily by a variety of market considerations including the supply, demand and liquidity of the stock and may be set before the counterparties to the transaction are known. The price a borrower is willing to pay for the temporary use of a security also turns on the borrower's other positions which it may need to hedge or reduce exposure to and the price set by others offering the same service in the market. While withholding tax rates are another factor that may be relevant to the fee a borrower is willing to pay, the price that is quoted to the borrower by an agent lender is ultimately a market-determined price.

68. Payments in respect of derivatives are also generally not dependent on nor fixed with reference to tax benefits. The "performance" leg of an equity swap is determined by reference to the performance of the underlying reference asset; the pricing of the funding leg depends on the prevailing cost of borrowing; and any dividend leg is priced according to a variety of market factors. The fact that the aggregate payments made by one party to another will sometimes include a component calculated with reference to dividend payments should not result in the payments made being interpreted as being fixed by reference to a tax advantage. These principles apply equally to futures contracts and other derivatives.

69. If the fee paid for an arrangement is not determined by reference to general market factors, but specifically reflects or depends upon an enhanced tax treatment that one of the parties to that arrangement obtains, and the Financial Institution has reason to know this, the transaction could

be disclosable if, upon review, a tax advantage is a main benefit of the transaction and that tax advantage is not one that was intended to be obtained under the relevant legislation. This would be a matter to determine based on the facts and circumstances.

Hallmark A3 – standardised documentation

70. Template contractual agreements for common financial instruments are published by various professional bodies. Such contracts include Global Master Securities Lending Agreements issued by the International Securities Lending Association (ISLA) and Master Agreements issued by the International Swaps and Derivatives Association (ISDA). These agreements have been developed over time for commercial reasons and ensure consistent allocation of commercial and legal risks between counterparties. They have not been developed as tax products or schemes and, to the extent they include tax clauses, these assign tax risks and responsibilities between the parties in a pre-agreed manner.

71. In practice, changes to these contracts are common and negotiations are conducted as part of on-boarding processes based on reviews undertaken by subject matter experts within financial institutions, including tax and legal. In addition, there are particular parameters that the parties must agree within the framework of the master agreement – e.g. which branches of legal entities are party to the agreement, what collateral is acceptable, and which margin maintenance, netting provisions and default interest rates apply.

72. On a trade by trade basis, parties will agree the specific terms of a particular transaction. The master agreements will operate as a framework under which the parties will act, but the specific agreed details of a trade will be contained in the trade confirmation between the parties. This is particularly the case for OTC derivative contracts whereby the confirmation, which will typically be heavily negotiated, will form the basis of the contract between the parties.

73. Due to the above reasons, we believe the correct view is that standard financial contracts should not be considered to meet hallmark A3 simply because of the use of template agreements as a starting point to negotiations. These agreements are neither, in substance, tax schemes, nor are they subject to minimal customisation when considered from the perspective of specific trades with specific clients.

74. If market standard financial contracts were altered so that:
    a. they specifically function as a mass-marketed, cross-border tax scheme;
    b. the main benefit of the scheme is a tax advantage; and
    c. that tax advantage is contrary to legislative intent

    then those arrangements will be subject to reporting under DAC 6.

75. The above approach is consistent with the OECD BEPS 12 final recommendations, which state that this hallmark is intended to capture what are often referred to as ‘mass-marketed schemes’ where the standardised terms relate specifically to the tax benefit and can deliver this tax benefit without being tailored to any material extent to the client’s circumstances. We believe that neither derivatives nor securities loans in normal circumstances could legitimately be described as “mass-marketed schemes” for tax purposes. We believe that ‘standardised documentation’ should be interpreted in this context, rather than being viewed as applying to commercially standardised framework documentation such as that outlined above. We note that this is also consistent with supplementary material published by some jurisdictions, for example paragraph 8.16 of HMRC’s consultation document.

Hallmark B2 – conversion of income to capital or another type of income

76. Where a securities loan crosses a dividend date, the lender would not receive a dividend but would receive a payment from the borrower that takes into account what would have been received had the lender not lent out their securities. Such arrangements should not fall within the definition of a conversion of income as the dividend is not converted – instead, the dividend would, as a matter of fact, be received by another party while the Lender would receive a payment under the securities lending agreement. Similarly, derivatives contracts may result in payments that differ from other hypothetical payments that would have been received if the client invested directly in underlying assets.

77. The receipt of income from one type of financial instrument rather than another should not be the intended target of hallmark B2. For example, it is expected that not every company resident in the EU is required to disclose the fact they have chosen to use a corporate structure, rather than operating as a sole trader, resulting in all of their investors receiving a potentially different type of income compared to what would have been received had they decided to operate as a sole trader. This is a logical position given there isn't a conversion, in a tax sense, from one type of receipt to another – simply a different payment made as a matter of fact.

78. We have seen support for the above view in supplementary material published by tax authorities. For example, the HMRC consultation document published on 22 July 2019 provides an example at paragraph 9.7 where an employer could remunerate an employee using a combination of salary and share options. The conclusion drawn is that the use of share options – which could be taxed as a capital gain – would not trigger hallmark B given share options are a "legitimate commercial choice" and "simply a choice has been made between different options". We would submit that this example is analogous to the investment in or use of different financial products, including securities lending and derivatives contracts.

Hallmark B3 – circular transactions

79. We would not consider a genuine securities lending transaction to fall within scope of hallmark B3. Although the transaction involves the lending and return of a fungible asset, assuming such transactions are priced at arm's length, they should not be considered a circular transaction. Further, the borrower in a securities lending transaction is usually required to provide the Lender with collateral in the form of cash, bonds or equities. In the event of default, the obligation to return the stock lent and the collateral are offset against each other – so-called "close out netting". The fact that such netting is available should not result in the application of Hallmark B3.

80. Where a financial transaction does include circular elements that net or remove any underlying commercial outcomes, and one of the main benefits of the arrangement is a tax advantage that is contrary to legislative intent, then such an arrangement may meet hallmark B3. Financial Institutions who act as intermediaries to such transactions may have a reporting obligation, if they have reason to know the arrangement is a reportable arrangement.

Hallmark C3 – double tax relief

81. We would note that if parties to a securities lending arrangement or derivatives contract participated in a transaction that allows them to obtain relief from double taxation in respect of the same item of income or capital, the transaction would likely be disclosable under Hallmark C3. A

Financial institution that acts as intermediary to such an arrangement would have a reporting obligation if they know, or have reason to know the arrangement is a reportable arrangement.

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