DFI 2013

May/June/Final

Derivatives & Financial Instruments

Contribution of articles

The editor welcomes original and previously unpublished contributions, which will be of interest to an international readership of tax professionals, lawyers, executives and scholars. Manuscripts will be subject to a review procedure and the editor reserves the right to make amendments which may be appropriate prior to publication. Manuscripts should be sent with a covering letter submitting biographical data and current affiliation to the editor. The author will be notified of acceptance, rejection or need for revision within eight weeks. Manuscripts may range from 3,000 to 12,000 words. Additional information may be obtained from the editor, e-mail m.peters@ibfd.org.

IBFD

P.O. Box 20237
1000 HE Amsterdam
The Netherlands
Tel.: 31-20-554 0100
Fax: 31-20-622 8658
www.ibfd.org

ISSN 1389-1863 / © 2013 IBFD

Contents

Volume 15 – Number 3 – May/June 2013

*Viva Hammer**

Life does not move in smooth curves. For years and years there's no change in the balance of powers, and then suddenly a single gunshot throws the world into war. For decades in the United States, practitioners have been bemoaning the increasing complexity of the taxation of financial products, its lack of connection with finance and the real world and the gaping lack of guidance in critical areas.

Then, without warning, on 24 January 2013, US House of Representatives Committee on Ways and Means chair Dave Camp released the Financial Products Tax Reform Discussion Draft as part of the Committee's broad effort to comprehensively reform the Internal Revenue Code.[1] The Discussion Draft aims to modernize the tax rules used to hide and disguise potentially significant risks through the abuse of derivatives and other novel financial products. It also aims to change the tax rules to provide greater simplicity and uniformity.

Commenting on the release of the draft, chair Dave Camp said:

> The US is a leader in the financial world, but our broken and antiquated tax code has failed to keep up with the rapid pace of financial innovation on Wall Street. The lack of consistent and comprehensive tax policy has also contributed to some corporate scandals and the recent financial crisis that devastated our economy and threatened our standing in the global community. Updating these tax rules to reflect modern developments in financial products will make the code simpler, fairer and more transparent for taxpayers; and it will also help to minimize the potential for abuse that has occurred in the past.

The Financial Products Discussion Draft includes several parts that the Committee identified as necessary to provide more uniform tax treatment of financial products, specifically:

- provide uniform tax treatment of derivatives;
- simplify business hedging rules;
- eliminate phantom tax resulting from debt restructurings;
- harmonize the tax treatment of bonds treated at a discount or premium on the secondary market; and
- prevent the harvesting of tax losses on securities.

Most significantly, the Financial Products Discussion Draft imposes mark-to-market treatment on all derivatives. It does not matter what kind of taxpayer enters into the derivative, where they enter in it, why they enter in it or what kind of contract they use. There is an exception for business hedging, but it does not include insurance companies, hedge funds or banks. Banks have been subject to mark-to-market for 20 years, and although there has been controversy, it is generally thought better than the prior system.

Mark-to-market has been widely supported in the academic and practitioner community. The Committee on Ways and Means is both brave and correct in putting the theory into legal language.

One large absence in the Financial Products Discussion Draft is guidance on international tax implications of the rules, particularly the source of income in derivatives. I believe that derivative income should be treated as business income subject to the business clauses of the standard tax treaties. It should not be treated as fixed and determinable annual or periodical income subject to withholding, nor treated as capital gain or loss. Derivatives involve no investment into an economy and do not belong with the capital gains clauses of the treaties.

In a remarkable example of transparency and an open democratic process, the Committee on Ways and Means has solicited feedback from a broad range of stakeholders, practitioners, economists and members of the general public on how to improve this proposed set of reforms.

Public hearings have been held on the various tax reform proposals. I gave testimony to Congress on the Financial Products Discussion Draft, as did four other practitioners from diverse fields. It was a rousing event, and a humorous one too. I recommend anyone who is interested in this field to view the hearing.[2]

The hard journey is yet to come. The Committee on Ways and Means has been bold in releasing its proposals, but the whole government has to agree on enactment, and, more importantly, to deal with the Budget, with sequestration and the greater problems facing the US economy.

Meanwhile, we labour still under the antiquated and complex financial products law, which makes good income for the lawyers but is very costly for the country. Let's hope that the next big change is triggered not by a gunshot but by some well-crafted tax reform.

* **Brandeis University, Waltham, Massachusetts. The author can be contacted at vhammer@brandeis.edu.**

1. The proposal can be found at http://waysandmeans.house.gov/uploadedfiles/leg_text_fin.pdf.

2. *See* http://waysandmeans.granicus.com/MediaPlayer.php?view_id=2&clip_id=449.

International

Laurent de La Mettrie, Patricia Songnaba and Donald Murre*

The European Financial Transaction Tax: The New Reality

The European Commission's new proposal for a financial transaction tax was issued on 14 February 2013 with Germany, France, Belgium, Estonia, Greece, Spain, Italy, Austria, Portugal, Slovenia and Slovakia as participating Member States. Whereas a year ago implementation seemed doubtful, it is now much more likely. The new proposal not only provides some clarifications and exemptions, but significantly broadens the scope of the financial transaction tax proposal by introducing the so-called "issuance principle", as well as strict anti-abuse measures.

1. Introduction

On 28 September 2011, the European Commission launched a proposal for an EU-wide financial transaction tax. Reactions to the proposal were mixed, with some Member States vehemently opposing it, while others voiced their support. In the impasse that followed, many thought that this would be the end of any financial transaction tax plans at a European level. However, one year later, in September 2012, Germany and France officially approached the Commission to launch the enhanced cooperation procedure under article 20 of the Treaty on European Union and articles 326-334 of the Treaty on the Functioning of the European Union.[1]

Nine other Member States (Belgium, Estonia, Greece, Spain, Italy, Austria, Portugal, Slovenia and Slovakia) voiced their support for enhanced cooperation, and the Commission submitted a proposal for enhanced cooperation to the Council. The European Parliament gave its consent on 12 December 2012. At the ECOFIN meeting of 22 January 2013, there was agreement in the Council to authorize a harmonized financial transaction tax, and on 14 February 2013 the Commission issued a new financial transaction tax proposal.[2]

The EU Commission expects the financial transaction tax to generate EUR 30-35 billion per year, corresponding to 1% of the participating Member States' tax revenues.[3] According to the EU Commission, the main objectives of the financial transaction tax are:
- tackling fragmentation of the Single Market that an uncoordinated patchwork of national financial transaction taxes would create;
- ensuring that the financial sector makes a fair and substantial contribution to public finances and covering the cost of the crisis, particularly as it is currently under-taxed compared to other sectors; and
- creating appropriate disincentives for financial transactions which do not contribute to the efficiency of financial markets or to the real economy.[4]

As to the latter point, only very limited theoretical work has been published on the impact of a financial transaction tax on the real economy, and whether this objective of the EU Commission will be met remains to be seen.[5]

2. Overview of the Changes in the New Proposal

The new draft addresses – at least partially – several concerns raised by the financial sector further to the initial draft. This includes mainly the following elements:
- restructuring transactions have been excluded, which is a welcome development;
- repo and securities lending transactions have not been excluded, but are now considered as a single transaction which halves their taxation; and
- UCITS and alternative investment funds (AIFs) will be exempt from the financial transaction tax for the issuance of shares/units but will still be taxed on redemptions.

Some measures are introduced at the request of participating Member States and/or the EU Parliament which will expand the scope of the financial transaction tax:

---

* **PwC Luxembourg, Tax Financial Services Partner and Asset Management Tax Leader; Tax Financial Services Senior Manager; Tax Financial Services Advisor.** **The authors would like to thank the other members of the PwC Luxembourg Financial Transaction Tax Team for their highly valued input, in particular: Kerstin Thinnes, Tax Financial Services Partner, Lionel Nicolas, Tax Financial Services Director, and Stéphane Defourny, Advisory Senior Manager.**

1. Enhanced cooperation requires at least nine EU Member States decide to proceed with an initiative proposed by the Commission, once it has proven impossible to reach unanimous agreement on it within a reasonable period. For a detailed explanation of the enhanced cooperation within the framework of the financial transaction tax, *see* European Commission, *Enhanced Cooperation on Financial Transaction Tax – Questions and Answers*, MEMO/12/799, 23 Oct. 2012, available at http://europa.eu/rapid/press-release_MEMO-12-799_en.htm.
2. Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/com_2013_71_en.pdf.
3. *Financial Transaction Tax through Enhanced Cooperation: Questions and Answers*, MEMO/13/98, 14 Feb. 2013, available at http://europa.eu/rapid/press-release_MEMO-13-98_en.htm.
4. Id.
5. R. Raciborski, J. Lendvai & L. Vogel, European Commission, *Securities Transaction Taxes: Macroeconomic Implications in a General-Equilibrium Model*, European Economy: Economic Papers 450 (Mar. 2012), at 24.

- the issuance principle, which allows the participating Member State to tax transactions on financial instruments issued in that participating Member State;
- the passport principle;
- an exemption for public entities involved in state debt; and
- several anti-avoidance measures.

3. Scope of the Financial Transaction Tax as It Stands Now

3.1. Financial institutions within the scope of the tax

3.1.1. Entities within the scope of the tax

The financial transaction tax is a tax due from financial institutions. The proposal does not provide for a general definition of "financial institutions", but instead provides a list of entities.[6] These entities include investment firms, organized markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies and special purpose vehicles. For most of these entities, specific reference is made to other EU legislation, such as the Solvency II Directive,[7] the MiFID Directive,[8] the Capital Requirements Directive,[9] the UCITS Directive[10] and the Occupational Pension Fund Directive.[11]

In addition, other entities are deemed to be financial institutions if more than 50% of the overall average net annual turnover consists of certain financial activities listed in the proposal. These activities include acceptance of deposits and other repayable funds, lending, financial leasing, guarantees and commitments, trading in financial instruments for its own account or for another, acquisition of holdings in undertakings, participations in or issuance of financial instruments or provision of services related thereto.[12] This means that for example treasury centres of industrial groups might fall into the scope of the financial transaction tax as well.

3.1.2. Exempt financial institutions

Certain parties which were deemed necessary for a more efficient and more transparent functioning of financial markets are not within the scope of the financial transaction tax. These include central counterparties, central securities depositories and international central securities depositories.[13] As from the new proposal, public bodies entrusted with the management of public debt when exercising their function are excluded, as well.[14]

3.2. Meaning of "financial transactions"

3.2.1. Financial transactions

For purposes of the proposal, a financial transaction includes:
- the purchase and sale of a financial instrument before netting and settlement;
- repurchase, reverse repurchase and securities lending and borrowing agreements;
- the transfer between group entities of the right to dispose of a financial instrument as owner, or equivalent operations implying a transfer of risk associated with the financial instrument;
- the conclusion or modification of derivative agreements; and
- the exchange of financial instruments.

The new proposal added the last measure as an anti-avoidance rule. The exchange of financial instruments is considered to give rise to twice a purchase and sale, so four taxable events.[15]

3.2.2. Transactions outside the scope of the tax

A number of activities which can be considered as aimed at citizens, such as the conclusion of insurance contracts, mortgage lending, consumer credits, enterprise loans and payment services are outside the scope of the proposal. Spot currency transactions are excluded, as well.[16] These services are not within the scope of the proposal, as they cannot be considered a financial transaction for purposes of the Directive or they fall under the primary market exemption explained below. However, if these products and services are securitized and traded as structured products, these transactions are within the scope again.

3.2.3. Exempt transactions

A number of financial transactions are excluded from the scope of the financial transaction tax. A first exemption is available for any transaction with the European Central

6. Art. 1(8) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
7. Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ EC L (Legislation), Edition 335 (2009), at 1.
8. Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, OJ EC L (Legislation), Edition 145 (2004), at 1-44.
9. Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ EC L (Legislation), Edition 177 (2006), at 1.
10. Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ EC L (Legislation), Edition 302 (2009), at 32, EU Law IBFD.
11. Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision, OJ EC L (Legislation), Edition 235 (2003), at 10.
12. Art. 1(8)(j) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
13. Art. 3(2)(a) and (b) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
14. Art. 3(2)(c) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
15. Explanatory Memorandum to the proposal, at 8, para. 4.
16. Because of the exclusion of spot currency transactions, the financial transaction tax is not the "Tobin tax" (although it is often mistakenly referred to as such), as the original tax envisaged by Tobin was exactly a tax on such transactions.

Bank, the European Financial Stability Facility, the European Stability Mechanism, the European Union in the management of its assets, balance of payment loans and similar activities, and a number of other activities involving the European Union.[17] Transactions with international organizations are excluded, as well.[18] This exemption was included to take into account the sovereign debt crisis and not to jeopardize monetary policies with additional taxation.

Lastly, the proposal provides for two exemptions to avoid any conflict between the financial transaction tax proposal and the Capital Duty Directive (2008/7/EC).[19] These are exemptions for primary market transactions and for financial transactions that form part of restructuring operations.[20] For purposes of the Capital Duty Directive, restructuring is to be understood as:

> (a) the transfer by one or more capital companies of all their assets and liabilities, or one or more branches of activity to one or more capital companies which are in the process of being formed or which are already in existence, provided that the consideration for the transfer consists at least in part of securities representing the capital of the acquiring company;
>
> (b) the acquisition, by a capital company which is in the process of being formed or which is already in existence, of shares representing a majority of the voting rights of another capital company, provided that the consideration for the shares acquired consists at least in part of securities representing the capital of the former company. Where the majority of the voting rights is reached by means of two or more transactions, only the transaction whereby the majority of voting rights is reached and any subsequent transactions shall be regarded as restructuring operations.
>
> 2. Restructuring operations shall also include the transfer to a capital company of all assets and liabilities of another capital company which is wholly owned by the former company.[21]

The term "primary market transactions" refers to the issuance of financial instruments. In the original proposal, there was a carve-out in the exemption for UCITS. The issuance of units in these funds would therefore be within the scope of the financial transaction tax. This was not in line with the Capital Duty Directive, however, and would require changing the latter. These funds are therefore now exempt upon the issuance of units and shares so as not to risk the raising of capital.

3.3. Meaning of Financial Instruments

3.3.1. Financial instruments

For the meaning of "financial instruments", the proposal refers to the MiFID Directive.[22] The MiFID Directive does not provide for a definition of "financial instruments", but defines by enumeration as follows:

(1) Transferable securities;
(2) Money-market instruments;
(3) Units in collective investment undertakings;
(4) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to securities, currencies, interest rates or yields, or other derivatives instruments, financial indices or financial measures which may be settled physically or in cash;
(5) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
(6) Options, futures, swaps, and any other derivative contract relating to commodities that can be physically settled provided that they are traded on a regulated market and/or an MTF;
(7) Options, futures, swaps, forwards and any other derivative contracts relating to commodities that can be physically settled not otherwise mentioned in C.6 and not being for commercial purposes, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognised clearing houses or are subject to regular margin calls;
(8) Derivative instruments for the transfer of credit risk;
(9) Financial contracts for differences.
(10) Options, futures, swaps, forward rate agreements and any other derivative contracts relating to climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event), as well as any other derivative contracts relating to assets, rights, obligations, indices and measures not otherwise mentioned in this Section, which have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are traded on a regulated market or an MTF, are cleared and settled through recognised clearing houses or are subject to regular margin calls.

In addition, financial instruments include structured products. The term "structured product" is defined in article 2(7) to mean "tradable securities or other financial instruments offered by way of securitisation within the meaning of article 4(36) of Directive 2006/48/EC [...] or by way of equivalent transactions involving the transfer of risk other than credit risk".

Transferable securities are not defined in Annex C of the MiFID Directive, but in article 4(18) of the MiFID Directive as:

(a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
(b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
(c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement de-

17. Art. 3(4)(b) to (e) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
18. Art. 3(4)(f) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
19. Art. 5(1)(e) and (2) together with art. 6(1)(a) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
20. Art. 3(4)(a) and (e) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
21. Art. 4 Directive 2008/7/EC of the European Parliament and of the Council of 12 February 2008 concerning indirect taxes on the raising of capital, OJ EC L (Legislation), Edition 46 (2008).
22. Article 2(3) of the proposal refers to section C of Annex I to Directive 2004/39/EC (MiFID Directive).

termined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures [...]

Money market instruments are defined in article 4 (19) of the MiFID Directive as "those classes of instruments which are normally traded on the money market, such as treasury bills, certificates of deposit and commercial paper, but excluding instruments of payment".

3.3.2. Derivatives

Derivatives are defined in article 2(4) of the proposal. A derivative agreement is "a financial instrument as defined in points (4) to (10) of Section C Annex I of the MiFID Directive (points (4) to (10) of the list cited above).

3.3.3. Comments

The category of financial instruments includes derivatives for purposes of the financial transaction tax proposal. Financial instruments are ultimately defined by reference to points (1) to (10) of Section C Annex I of the MiFID Directive, and derivative agreements by reference to points (4) to (10) of that same provision. The provisions referring to derivatives should be considered as the exception to the provisions dealing with financial instruments, as a *lex specialis*.

3.4. Territorial scope of the financial transaction tax

3.4.1. Deemed establishment

Perhaps one of the most challenging and complicated rules of the financial transaction tax proposal is the manner in which the place of establishment of financial institutions and other parties involved in a financial transaction is determined. Only financial transactions of which one of the parties is a financial institution established in a participating Member State are liable to financial transaction tax, which makes the establishment criterion so essential. Establishment in the context of the financial transaction tax should not be understood as the place of incorporation or similar corporate law criteria, but rather as "deemed establishment", to significantly expand the territorial scope of the financial transaction tax.

In order to do so, the proposal provides for a cascade of several criteria to determine the establishment of financial institutions and non-financial institutions.[23] If the entity is deemed to be established in different participating Member States by several criteria, it is the first criterion in the list which will take precedence to determine which State will levy the financial transaction tax.

Establishment of financial institutions

The *first* criterion is the authorization of the financial institution by the regulator of a participating Member State for transactions covered by that authorization.[24]

The *second* criterion in the cascade is the so-called "passport". If the financial institution is not authorized by that participating Member State, it may well be that it will be deemed to be established because it is authorized or otherwise entitled to operate, from abroad, as a financial institution in a participating Member State.[25]

The *third* criterion in the cascade, if the two first criteria have not been fulfilled, is having a registered seat in a participating Member State.[26]

The *fourth* criterion is a permanent address, and if no permanent address can be ascertained, then the usual residence of the financial institution. One should bear in mind that a financial institution does not necessarily have to be a legal person, but may be an individual, as well (such as a broker) – although this would be quite exceptional.[27]

The *fifth* criterion is the disposal of a branch within a participating Member State, in respect of financial transactions carried out by that branch.[28]

The *sixth* criterion refers to the previous five. If a financial institution is involved in a financial transaction with another financial institution established in a participating Member State pursuant to any of the above five criteria, or with a non-financial institution which is established in a participating Member State, it is deemed to be established in that Member State, as well. It does not matter if the party is acting for its own account or for the account of another person, or for another party to the transaction.

The *seventh* criterion in the cascade refers to the issuance principle, which is considered further below. It is therefore not a separate criterion, but a criterion to determine deemed establishment, as well.[29]

Establishment of non-financial institutions

In the case of the deemed establishment of non-financial institutions which are part of a financial transaction, comparable criteria apply as for financial institutions. These criteria are registered seat, and in the case of a natural person

23. Art. 4 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

24. Art. 4(1)(a) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

25. Art. 4(1)(b) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

26. Art. 4(1)(c) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

27. Art. 4(1)(d) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

28. Art. 4(1)(e) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

29. Art. 4(1)(g) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

permanent address or in the absence thereof, usual residence, branch if the branch participates in the transaction, and the issuance principle referred to below.[30]

3.4.2. *Newly introduced issuance principle*

Article (4)(1)(g) and article (4)(2)(c) introduce the issuance principle for financial institutions and other parties to a financial transaction as a last criterion to determine deemed establishment. If a financial institution is a party acting for its own account, for the account of another person, or in the name of a to a financial transaction concerning certain financial instruments issued within the territory of a participating Member State, that financial institution is deemed to be established in such Member State.

The meaning of "financial instrument and structured products [...] issued within the territory of a Member State" is referred to in article (2)(11) of the proposal, and is such an instrument issued by a person who has its registered seat, or in the case of a natural person, its permanent address or, if no permanent address can be ascertained, its usual residence in that Member State. These financial instruments are those mentioned in Section C of Annex I of the MiFID Directive, except those mentioned in (4) to (10) in that section (notably options, swaps, contracts for difference, etc.) which are not traded on an organized platform. The financial instruments affected by this issuance principle are therefore in first order:
– transferable securities;
– money-market instruments; and
– units in collective investment undertakings.

As the application of the issuance principle to derivatives is not clear, the Economic and Monetary Affairs Committee of the European Parliament issued a draft report[31] which proposes certain amendments to clarify the application.

3.4.3. *Absence of a link between economic substance of transaction and participating Member State*

The proposal leaves some limited leeway, however. Financial institutions or non-financial institutions which are within the scope of the financial transaction tax by way of the deemed establishment criteria are permitted to demonstrate that there is no link between the economic substance of the transaction and the territory of a participating Member State. However, the proposal does not provide guidance regarding how to demonstrate this.

Following the former proposal, the Commission issued several "technical fiches" explaining in more detail certain concepts in the proposal.[32] The technical fiche on the residence principle and the territoriality of the tax has provided some explanation. This fiche gives the example of a Chinese bank and a Chinese investment firm which act in the name of an industrial company established in Germany, which conclude a steel future contract in China for operations of the German company in China. Following the rules of deemed establishment, both financial institutions are deemed to be established in Germany and financial transaction tax is due in principle, unless the Chinese financial institutions can demonstrate that there is no link between the economic substance of the transaction and the territory of Germany. According to the Commission, such proof is deemed to be not available if the operations of the German company in China have an impact on the balance sheet of the German headquarters.

It seems therefore quite difficult to demonstrate the absence of a link, and additional guidance will be needed.

3.4.4. *Comments*

The issuance principle was inserted at the request of certain Member States. It broadens the deemed establishment principle and significantly increases the scope of application of the financial transaction tax. Financial institutions located in non-participating Member States and states outside the European Union will be taxable if they trade in financial instruments issued in participating Member States.

The fact that the issuance principle is introduced not only for financial institutions but for other parties to the financial transactions does not have an added value. Only financial transactions with a financial institution involved fall within the scope of the tax, and that financial institution will already be deemed to be established in a participating Member State if the transaction concerns a financial instrument issued in a participating Member State.

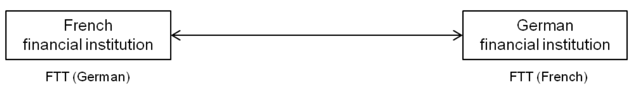
A Luxembourg financial institution will be deemed to be established in a participating Member State if the transaction concerns a financial instrument issued in that state.

Article 14 states that depository receipts representing securities should be considered equated to those securities for the purpose of the issuance principle.

3.4.5. *Deemed residence principle: examples*

For the sake of clarity, some illustrative examples of the application of the deemed establishment principle are provided below, accompanied by a brief explanation.

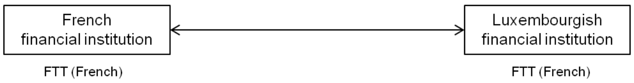
Figure 1



This is the basic situation. Two financial institutions, both established in a participating Member State, engage in a financial transaction. Financial transaction tax (FTT) will be payable by both, in the participating Member State where the institution is deemed to be established.

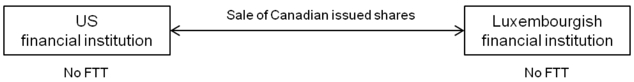
30. Art. 4(2) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
31. Economic and Monetary Affairs Committee, *Draft Report on the Proposal for a Council Directive Implementing Enhanced Cooperation in The area of Financial Transaction Tax*, 19 Mar. 2013, ECON_PR(2013)507928.
32. This is a non-paper and only commits the Commission's services involved in the preparation, not the Commission itself.

Figure 2



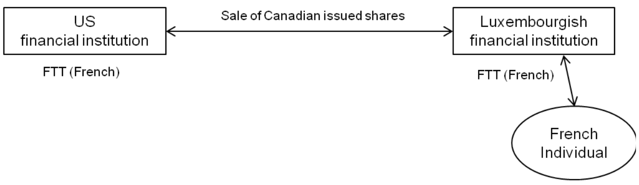
In this case one of the parties is established outside the financial transaction tax zone, as Luxembourg is not a participating Member State. By virtue of the sixth criterion (financial transaction of a financial institution with another financial institution located inside the financial transaction tax zone), the Luxembourg financial institution is deemed to be established in France and the French financial transaction tax is due from both the French financial institution and the Luxembourg financial institution.

Figure 3



In this case both financial institutions are established outside the financial transaction tax zone. As the transaction concerns the sale of shares issued in Canada, the issuance principle will not be applicable.

Figure 4



In this case the Luxembourg financial institution is deemed to be established in the financial transaction tax zone, as it is acting for a natural person established in France by virtue of the sixth criterion. The US financial institution is, by transacting with the Luxembourg FI, deemed to be established in the financial transaction tax zone, as well. The French financial transaction tax will apply for both financial institutions.

Figure 5

In this case, both the US and the UK financial institution deal with a financial institution established in the financial transaction tax zone. As such, they are deemed to be established in Germany.

3.5. Taxable event, tax rate and tax collection

3.5.1. Chargeability

The time of chargeability is defined when the transaction occurs, i.e. before netting and settlement. Any subsequent cancellation or rectification of the transaction will not cause the financial transaction tax not to be chargeable, with the exception of cancellation or rectification in the case of errors.[33]

3.5.2. Taxable base

If the value determining the taxable base of the financial transaction is denominated in a currency other than that of the participating Member State, the exchange rate will be the latest selling rate recorded at the time the financial transaction tax becomes chargeable, on the main exchange market of that state, or at an exchange rate determined by reference to that market in accordance with the rules of the state.[34]

Financial instruments (excluding derivative agreements) and derivative agreements have different natures and characteristics, which implies different taxable amounts. For financial instruments excluding derivative agreements, this is the consideration paid or owed. This consideration should, however, be at arm's length. The arm's length criterion also applies in the case of intra-group transactions which cannot be qualified as a purchase and sale.[35]

In the case of derivative agreements, either purchase and sale or conclusion and modification of derivative agreements, the taxable amount of the financial transaction tax is the notional amount. If a derivative is agreed using more than one notional amount, it is the highest amount which will be the taxable amount.[36] In most cases, the notional amount of a derivative is a fictitious reference and may deviate considerably from the market price of the derivative. In many cases the lower rate of 0.01% does not reflect a the relation between the market price and the notional amount, as the latter can be much more than 10 times the market price.[37]

3.5.3. Rates

The proposal provides for minimum rates. The participating Member States may introduce higher rates as long as they apply the same rate consistently for all transactions falling within the same category, being either financial instruments excluding derivatives, or derivatives.

The minimum rate for derivative agreements will be 0.01% on the notional amount, and 0.1% for the remaining financial transactions.[38]

3.5.4. Liability for the financial transaction tax

In principle, each financial transaction party to a taxable financial transaction is liable for payment of the finan-

33. Art. 5 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
34. Art. 8 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
35. Art. 6 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
36. Art. 7 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
37. For more details concerning the impact of the financial transaction tax on derivatives, *see* D. Murre, *The European Financial Transaction Tax: Issues for Derivatives, Structured Products and Securitization*, 14 Derivs. & Fin. Instrums. 1 (2012), Journals IBFD.
38. Art. 9 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

cial transaction tax. It does not matter whether the financial institution acts either for its own account or for the account of another if it is acting in the name of a party to the transaction, or that the transaction has been carried out on its account.[39]

An exemption exists for financial institutions acting in the name or for the account of another financial institution. In such case, it is the other financial institution which will be held liable for payment of the financial transaction tax. However, this does not exclude liability under the rules cited below.[40]

The financial transaction tax will be payable by the financial institution to the participating Member State where it is deemed to be established. If the financial transaction tax is not paid within the time limit set out below, each party to the transaction will be held jointly and severable liable for payment, even non-financial institutions.[41] The importance of the latter provision should not be underestimated as a powerful tool of enforcement. If a financial institution located outside a participating Member State dealing with a non-financial institution refuses to pay the financial transaction tax, the non-financial institution will be liable for payment of such tax. In addition, participating Member States can provide that a person other than the one cited above may be made jointly and severable liable for payment of the financial transaction tax. This opens the door for liability of parties which are, in principle, exempt, such as clearing houses and central securities depositories (CSDs).[42] In addition, it increases enforceability of the financial transaction tax outside the financial transaction tax zone. The Draft Report of the Economic and Monetary Affairs Committeeprovides additional rules.[43]

3.5.5. *Collection*

Collection of the financial transaction tax will be challenging. This burden falls upon the Member States, and they will need to make sure that such tax is effectively paid by laying down rules for registration, accounting and reporting. The Commission may adopt delegated acts and implementing acts to provide additional measures or uniform methods of collection.[44]

The financial transaction tax should be paid at the moment the tax becomes chargeable if the transaction is carried out electronically, and within three working days the tax becomes chargeable for all other transactions.[45]

The parties liable for the financial transaction tax must submit a tax return for each month with all the information needed to calculate such tax that has become chargeable during that month. This return must be submitted by the tenth day of each month following the month to which the tax return relates. The tax will therefore be paid before the submission of the tax return, not after.[46]

In addition, financial institutions must keep at the disposal of the tax authorities all relevant data relating to financial transactions that they have carried out for a period of five years. When laying down rules for this, the participating Member States need to take into account any other reporting obligations they already imposed on financial institutions following the MiFID Directive.[47]

3.5.6. *Newly introduced anti-abuse measures*

The former proposal stated that the participating Member States must adopt measures to prevent tax fraud and evasion (article 12 of the current proposal).

In addition, the new proposal introduces a provision dealing directly with depositary receipts and similar securities, as well as a general anti-abuse rule.[48] For purposes of the issuance principle, a depository receipt or similar security issued with the essential purpose of avoiding tax on transactions in the underlying security will be deemed to be issued in the participating Member State.

The general anti-abuse rule is inspired on the Commission Recommendation of 6 December 2012 on aggressive tax planning, and is very broadly defined to tackle almost any form of avoidance.[49]

3.6. Final provisions

Some final provisions ensure proper implementation of the financial transaction tax within the participating Member States. First, the states must not maintain or introduce taxes on financial transactions other than the European financial transaction tax. Other provisions deal with the possibility of the Commission to adopt delegated acts.[50]

Finally, the proposal provides that the participating Member States should adopt and publish by 30 Septem-

39. Art. 10(1) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
40. Art. 10(2) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
41. Art. 10(3) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
42. Art. 10(4) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
43. Economic and Monetary Affairs Committee, *Draft Report on the Proposal for a Council Directive Implementing Enhanced Cooperation in the Area Of Financial Transaction Tax*, 19 Mar. 2013, ECON_PR(2013)507928.
44. Art. 10(1) and (2) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
45. Art. 11(5) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
46. Art. 10(3) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
47. Art. 10(4) Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
48. Arts. 13 and 14 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.
49. OJ L 338, 12 Dec. 2012, at 41.
50. Arts. 16 to 19 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

Figure 6

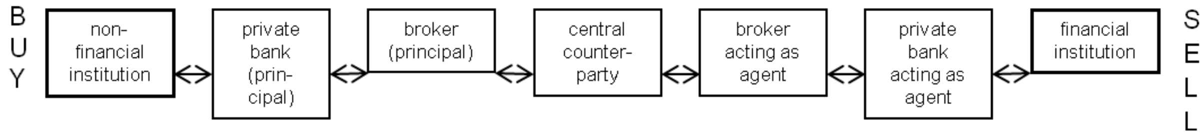


Figure 7

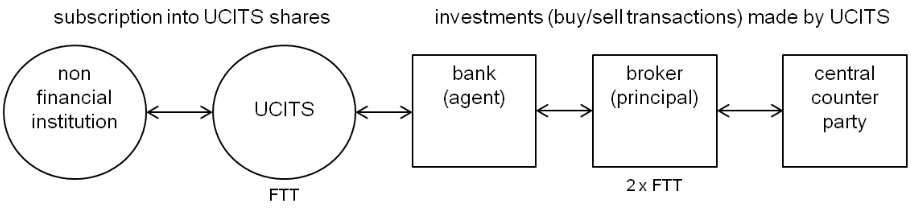
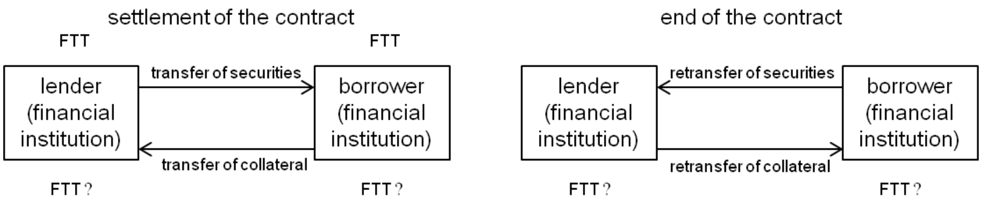


Figure 8



ber 2013 at the latest the rules necessary for implementation. These rules would need to enter into force as from 1 January 2014.[51] From a political and practical perspective, it seems unlikely that these deadlines could be met.

4. Application to Specific Transactions

4.1. Buy/sell transaction in financial instruments

As illustrated in Figure 6, a sale of a financial instrument normally involves more than one party. This chain of financial transactions may entail more than one taxable event so that the total tax burden is significantly higher than 0.1% on the arms length consideration. In this specific case the total tax burden will amount to 0.5%. Important elements affecting the transaction chain include the number of parties, whether they act in the capacity as agent or as principal (brokers) and whether they are exempt or not (central counterparties).

4.2. Funds: UCITS, alternative investment funds

UCITS are regarded as financial institutions for purposes of the proposal. In the initial proposal, the issuance of UCITS shares was subject to financial transaction tax, as it was a carve-out from the primary market exemption. However, as such, it was not in line with the Capital Duty Directive, which would need amendment if the initial proposal were to be introduced. The new proposal removed the carve-out all together, and the issuance of UCITS shares falls under the primary market exemption (*see* Figure 7).

Despite concerns voiced by the sector after the initial proposal, UCITS funds remain fully taxable on their investment side when dealing with parties deemed to be established in a participating Member State.

4.3. Repos and securities lending

After the initial proposal there was uncertainty as regards whether repo transactions and securities lending would give rise to only one taxable financial transaction or two (*see* Figure 8). The new proposal affirmed that this kind of transaction gives rise to only one taxable transaction, as the financial instrument is put at the disposal of the other party for only a limited period of time. This means that the financial transaction tax must be paid twice, once at the level of the lender and once at the level of the borrower (instead of four times). It is not clear from the proposal if the transfer of collateral during such transactions is treated as a separable transaction, but this would make the most sense, in light of the reason above.[52]

5. Impact of the Financial Transaction Tax

5.1. Impact on the sector

Financial institutions will need to adapt to the new reality and will be confronted with a number of challenges. They will need to review their trading strategy, keeping in mind the broad territorial scope of the financial transaction tax, in particular the location of their counterparties and customers, the location of clearing and settlement and the number of parties involved in the transaction chains, as well as the question as to whether they are acting as agent or principal. Investment strategies will need to consider the frequency of transactions, the nature of the invest-

51. Arts. 20 and 21 Proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax, COM(2013) 71 final 2013/0045 (CNS), 14 Feb. 2013.

52. For a study dealing extensively with the effect of the financial transaction tax proposal on repo-transactions, *see* R. Commoto, *Collateral Damage: The Impact of the Financial Transaction Tax on the European Repo Market and Its Consequences for the Financial Markets and the Real Economy*, International Capital Market Association, 8 Apr. 2013.

ments and their consequences with regard to financial instruments versus derivatives, and the issuance principle.

Of the financial institutions that will most likely be affected, most are financial intermediaries, as their margins are low and extra financial transaction tax costs may make brokerage downright unprofitable.

More broadly, the liquidity of the financial sector, such as banks and organized markets, particularly in the financial transaction tax zone, could be severely affected, as repo transactions and security lending are still included in the proposal, and could still give rise to multiple taxable events (as explained above).

On the operational side, business processes such as calculation, reporting, accounting and oversight and control processes need to be revised. IT systems for trade booking, settlement and financial reporting will need to be adjusted, as well.

Not only financial institutions will be affected. The inclusion in the proposal of finance and holding companies may affect operational groups, as well. The exemption for primary market transactions does not extend to underwriting, and the issuance of shares and bonds will become more cumbersome and costly for operational companies due to financial transaction tax effects down the chain. These issues for capital raising apply not only to companies, but governments as well, as market liquidity for government bonds will probably also decrease as generally borrowing costs will increase.

5.2. Third countries: example – Luxembourg

Financial centres outside the financial transaction tax zone will be equally affected. It does not matter if they are part of the European Union or not. Relocation from one state outside the financial transaction tax zone to another will therefore not have the desired effect, as the deemed establishment rules will equally apply.

As to enforceability of the financial transaction tax rules outside the financial transaction tax zone, the possibility to make all the parties to the transaction jointly and severable liable will ensure in most cases that the financial transaction tax will be effectively paid.

The taxation of UCITS and alternative investment funds should be one of the main concerns for Luxembourg. Indeed, in addition to taxation at the portfolio level, the mere redemption of units/shares in Luxembourg funds by investors resident in a participating Member State will give rise to the application of the financial transaction tax, although Luxembourg funds should be less impacted than funds domiciled in participating Member States.

Also, the new draft does not provide clarity regarding how proof may be provided in cases where there is no link between the economic substance of the transaction and the territory of a participating Member State. It would have been useful for Luxembourg financial institutions to be able to rely on a kind of safe harbour rules when they are transacting with or servicing non-EU parties.

6. Conclusion

When the first proposal was introduced at the end of 2011, many believed that the Financial Transaction Tax Directive would remain a proposal and nothing more, as political discord surrounded the project. With 11 Member States opting for the introduction of the financial transaction tax, a new reality awaits as implementation is certain.

The new proposal only partially responded to the concerns of the financial sector, by for example clarifying that repo and security lending transactions give rise to only one taxable transaction, and excluding restructuring and the issuance of shares in UCITS to bring the proposal in line with the Capital Duty Directive.

The new proposal significantly broadens the scope of the Directive upon the demand of certain Member States by introducing the passport and issuance principle and introducing several anti-abuse rules.

The result is that the scope of the financial transaction tax will be huge due to the broadly defined deemed establishment rules and the number of financial transactions and institutions involved. The United Kingdom recently announced that it would take the financial transaction tax issue to the European Court of Justice to address the broad territorial scope, but the outcome remains to be seen.

The effective tax rate could be much higher than 0.1% on the arms length consideration or 0.01% on the notional amount, as participating Member States may introduce higher rates and due to the number of parties involved in already straightforward transactions such as the sale and purchase of shares. The proposal envisages that the financial transaction tax rules will be in force from 1 January 2014. If this date remains the goal, challenges for Member States and financial institutions to implement the financial transaction tax will be significant.

One possible effect of the broad scope of the financial transaction tax may be that the financial industry model as we know it will be significantly redesigned. It remains to be seen whether the real economy will benefit from this new financial model that the European Commission envisages, as there is now conclusive evidence for this. All in all, the financial transaction tax remains a highly political and ideological topic, and while only two years ago it could be regarded as a theoretical exercise, implementation now is much more likely.

Silvain F.M. Niekel
and Martijn F. Nouwen*

The Current Tax Avoidance Debate and European Banks

This article presents an overview of previous and future policy initiatives addressing aggressive tax planning and trends on this topic, and how banks are impacted, with a specific emphasis on developments in the European Union.

1. Introduction

Tax practitioners and tax managers of multinationals are finding themselves in the middle of a perfect storm as national, supranational and international tax legislatures are stepping up their efforts to tackle perceived aggressive tax planning. Banks, in particular, seem to be targeted by these measures, either as alleged culprits or accomplices. This article presents an overview of previous and future policy initiatives addressing aggressive tax planning and trends on this topic, and how banks are impacted, with a specific emphasis on developments in the European Union. The authors distinguish between those developments that are specifically related to the banking industry and those that are less industry -focused but also impact banks. In addition, the authors distinguish between developments that relate to the banks' own tax position and those that relate to the banks' clients.

2. Setting the Scene: the Current Tax Avoidance Debate[1]

In these days of budget deficits and bailouts, there is an increased attention by national,[2] supranational[3] (e.g. the European Union) and international[4] (e.g. the OECD, the United Nations, the G8, and the G20) institutions to come up with targeted policy responses addressing tax avoidance. This tax avoidance debate has also struck a nerve with the general public in these times of austerity measures, leading to front page headlines and parliamentary hearings focused on multinationals. The increased media attention has turned the tax debate into a hot topic of discussion on the streets, in the bars, and at office coffee machines.

The criticism on multinational taxpayers is based on two ideas. First, if national governments have to massively support businesses and even entire economies out of tax revenue to get through these economically hard times, then profitable businesses should contribute at least a "fair share" compared to the man in the street who pays more tax while public services are cut. Second, if this abuse of mismatches had not transpired, the southern EU Member States and developing countries would not have had such budgetary problems and the Eurozone would not have been in so much trouble.

Unlike other corporate groups, banks are forced to fight this battle on two fronts. First, the general public and many non-governmental organizations and politicians view banks as being part of the group of multinational taxpayers that are fiscally over-privileged as compared to the man in the street. In addition, they are also seen as assisting their clients (either corporate or high net-worth individuals) to avoid paying taxes by designing and accommodating their sophisticated tax planning structures. The impact on banks from this press exposure and political attention should certainly not be underestimated; consumer boycotts, brand damage, increased tax administration scrutiny and increased regulatory pressure are items on boardroom tables.

The issue of perceived aggressive tax planning is, by its nature, a transnational one that can be effectively addressed only by concerted international action. This article therefore focuses in particular on EU and OECD policy initiatives. In order to analyse the current tax avoidance debate in the proper historical perspective, one should consider the stream of initiatives that have been launched in the last few years at an ever accelerating pace. These policy developments can be summarized as follows.

* **Silvain Niekel is Partner International Tax, Financial Services, Ernst & Young Belastingadviseurs LLP. Martijn Nouwen is academic researcher at the Amsterdam Centre for Tax Law at the University of Amsterdam and tax advisor at Ernst & Young Belastingadviseurs LLP.**

1. *See also* speech of M.F. Nouwen at the Amsterdam Centre for Tax Law Conference, "The European Union's struggle with mismatches and aggressive tax planning", Amsterdam (5 Apr. 2013).
2. For example, UK Chancellor of the Exchequer G. Osborne stated: "Britain has cut its corporation tax rate by more than any other country in the G20 over the past two years, a message to the world that we are open for business that has seen companies return to Britain, and helping to create and secure thousands of jobs and millions in investment. But our commitment to the most competitive corporate tax system goes hand in hand with our call for strong international standards to make sure that global companies, like anyone else, pay the taxes they owe". *SeeGeorge Osborne pushes for crackdown on tax avoidance by multinational companies*, The Telegraph (16 Feb. 2013).
3. For example EU Commissioner for Taxation A. Šemeta stated: "Around one trillion euros is lost to tax evasion and avoidance every year in the European Union. Not only is this is a scandalous loss of much-needed revenue, it is also a threat to fair taxation. While Member States must toughen national measures against tax evasion, unilateral solutions alone won't work. In a Single Market, within a globalised economy, national mismatches and loopholes become the play-things of those that seek to escape taxation. A strong and cohesive EU stance against tax evaders, and those that facilitate them, is therefore essential". *See* "Clamping down on tax evasion and avoidance: Commission presents the way forward", European Commission press release IP/12/1325 (6 Dec. 2012).
4. For example OECD Tax Policy Director P. Saint-Amans stated: "For a few years now, press campaigns have been raising awareness of the fact that laws can result in very low taxation of multinationals, particularly those involved in the digital economy. There is a strong push from some key 'G20' countries to address this issue quickly, which is new". *See Tax loopholes closing for multinationals*, The Dominion Post (14 Jan. 2013).

Specific

Tax position of banks		
2013	Country-by-country tax reporting	EU
2010	Tax risks of bank losses	OECD
2010	Code of Conduct for banks	OECD
2009	Transparent tax compliance by banks	OECD
2008	Tax intermediaries	OECD

Tax position of banking clients		
2013	EU FATCA	EU
2010	FATCA	US
2000/09	Improving access to bank information for tax purposes	OECD
2003	Savings Directive (2003/48)	EU

Generic

1998/2013	EU Code of Conduct Group on Business Taxation	EU
2012	Action plan against tax fraud and tax evasion	EU
2012	Project on base erosion and profit shifting	OECD
2012	Hybrid mismatch arrangements report	OECD
2011	Improved administrative cooperation	EU
2007	Third Anti-Money Laundering Directive	EU

3. Industry-Specific Developments

3.1. Tax position of banks

3.1.1. OECD report on banks as tax intermediaries: 2008

In view of the major crackdown by the US Internal Revenue Service (IRS) on corporate tax shelters and the associated controversy in the media[5] and politics in the early 2000s,[6] it is somewhat remarkable that it took the OECD quite some time to get to grips with sophisticated cross-border tax planning strategies.[7] In September 2006, the heads of national tax administrations from more than 30 countries met in Seoul under the auspices of the OECD's Forum on Tax Administration (FTA). The statement following the FTA meeting (Seoul Declaration) emphasized concerns about corporate governance and aggressive tax planning schemes.[8] The Seoul Declaration marks an important milestone in the fight against tax avoidance, as it specifically identified financial institutions as facilitators of aggressive tax structures. The FTA established a study team to further investigate this topic.

The report of this study team, titled "Study into the Role of Tax Intermediaries", was issued in January 2008,[9] concurrently with the next FTA meeting in Cape Town. The FTA considered that especially investment banks play a significant role in developing and implementing aggressive tax structures, both for clients and for proprietary trading. However, the study team was unable to reach any final conclusions on this point. Accordingly, the FTA committed to undertake a follow-up study focused on investment banking.

3.1.2. OECD report on transparent tax compliance by banks: 2009

The report resulting from the Cape Town follow-up study was released in 2009,[10] as a discussion paper for the next FTA meeting in Paris. The core message of this report was that tax authorities were experiencing difficulties in understanding complex structured financial transactions as typically used and promoted by (investment) banks.[11] The report contained various recommendations not only for tax authorities, but also for banks. For example, it was suggested that banks should consider tax risks as part of their governance framework, that banks' tax departments should strive for greater transparency regarding structured financial transactions, and that banks should share their risk views on potentially uncertain tax treatments with tax authorities as part of an enhanced relationship model. The report served as a clear indicator that banks would be facing higher scrutiny with respect to certain financial instruments and transactions.

3.1.3. OECD code of conduct in tax Matters for banks: 2010

Following the 2009 report on transparent tax compliance by banks, the FTA subsequently examined whether there were ways for countries to work together and build on the experiences of the United Kingdom[12] and South Africa[13] with respect to their respective codes of practices on taxation of banks. The report resulting from this study was issued in 2010 and set out some guidelines for both tax authorities and banks.[14] Specifically with respect to tax planning, the voluntary code of conduct required banks to agree not to undertake or promote "aggressive tax planning" in their own tax affairs, in products and services they offer to clients, and in their remuneration packages for employees. The report failed to provide a clear

5. *See* e.g. M. France, *The Rise of the Wall Street Tax Machine*, Business Week 3/2003, at 84; C. Groobey, *Enron accusations force banking rethink*, Intl. Fin. L.Rev. (Nov. 2003), at 26-29.
6. The Treasury Department already issued a report on tax shelters in 1999, "The Problem of Corporate Tax Shelters" (July 1999). *See also* Joint Committee on Taxation, "Background and Present Law Relating To Tax Shelters" (19 Mar. 2002)(in preparation of a public hearing before the Senate Committee on Finance).
7. In April 2004, tax officials of Australia, Canada, the United Kingdom and the United States agreed to establish a joint task force to identify and curb abusive tax transactions: the Joint International Tax Shelter Information Centre (JITSIC). Subsequently, Japan, South Korea and China have joined this task force, as well.
8. Final Seoul Declaration, Third meeting of the OECD Forum on Tax Administration, 14-15 Sept. 2006.
9. OECD, "Study into the Role of Tax Intermediaries" (2010).
10. OECD, "Building Transparent Tax Compliance by Banks" (2009).
11. Appendix 2 to the Report included various examples of typical cross-border tax arbitrage transactions, such as repo transactions and foreign tax credit generator schemes.
12. For the UK Code of Practice on Taxation for Banks, *see* http://www.hmrc.gov.uk/thelibrary/code-practice-tax-banks.pdf.
13. For the press release on this accord, *see* http://www.info.gov.za/speeches/2009/09020310451009.htm.
14. OECD, "A Framework for a Voluntary Code of Conduct for Banks and Revenue Bodies" (2010).

definition of "aggressive tax planning", but made reference in this regard to (i) tenable tax positions with unintended tax revenue consequences and (ii) a lack of disclosure about the uncertainty of certain tax positions taken in the tax return. Where a bank is unclear about whether a proposed transaction will be seen as aggressive tax planning, it should ideally discuss this transaction with the tax authorities, according to the report.

3.1.4. OECD report on tax risks of bank losses: 2010

In the wake of the financial and economic crisis, the OECD issued the report "Addressing Tax Risks Involving Bank Losses"[15] in September 2010 examining tax risks involving bank losses from the perspective of both taxpayers and tax authorities. The report found a source of tax risk in the opportunities for banks to exploit differences between country rules through aggressive tax planning. The report made a number of recommendations to tax authorities and to banks as to how tax risks involving bank losses might be further reduced.

3.1.5. EU country-by-country reporting for banks: 2013

In response to the increasing perception by the public and politicians that large multinational companies are using complex arrangements to avoid paying their fair share of tax, the calls for greater transparency in tax matters have become increasingly louder. One of the mechanisms promoted to improve tax transparency is country-by-country reporting.[16] Various international tax transparency initiatives are currently in force or being proposed, but they tend to focus on the extractive industry.[17] It was therefore quite a surprise that a country-by-country reporting provision was included as a last-minute addition to the Capital Requirements Directive IV (the CRD IV), which seeks to implement the requirements of Basel III into EU law.[18]

Under the proposed text of the CRD IV, all financial institutions regulated under that directive (i.e. banks and investment companies) will be required to publish, for each group entity and for each country, the following information:

(1) name, nature and geographical location of their activities;
(2) number of full-time equivalent basis employees;
(3) turnover;
(4) pre-tax profit or loss;
(5) taxes paid; and
(6) subsidies received.

During 2014, the Commission will first review the components (4) through (6) provided by banks on a confidential basis and assess whether, after giving due regard to any adverse consequences, this information should be made public from 2015.

3.2. Tax position of banking clients

3.2.1. OECD initiatives in the area of banking secrecy

For a long time already, the OECD has expressed concerns about the extent to which OECD member countries have access to bank information for tax purposes. The March 2000 report of the OECD Committee on Fiscal Affairs[19] suggested that all OECD member countries should permit access to bank information, directly or indirectly, for all tax purposes so as to enable tax authorities to engage in effective exchange of information with their treaty partners. In that same year, the Global Forum on Transparency and Exchange of Information for Tax Purposes (the Global Forum) was established as the multilateral framework within which work in the area of transparency and exchange of information has been carried out.[20] The Global Forum has been closely monitoring the progress made in implementing its proposed standards and has issued various progress reports. Its most recent report mentions that 100 country reviews have been performed and that the number of jurisdictions that have joined the Global Forum has grown to 119.[21] As a next step, the Forum will now begin assigning an "overall rating" to each jurisdiction, indicating its compliance in practice with the OECD standards in this area. It is expected that the first ratings of 50 countries will be finalized by the end of 2013.

3.2.2. EU Savings Directive

In 2003, after years of intense discussion, the European Union enacted the Savings Directive (2003/48), which came into effect on 1 July 2005.[22] Measures equivalent to, or the same as those provided for by the Savings Directive also came into effect in Andorra, Liechtenstein, Monaco, San Marino, Switzerland and certain relevant dependent or associated territories of the EU Member States.

15. OECD, "Addressing Tax Risks Involving Bank Losses" (2010). This report was followed a year later by a more generic analysis of the challenges faced by tax authorities with respect to loss utilization by multinationals. *See* OECD, "Corporate Loss Utilisation through Aggressive Tax Planning" (2011).
16. The introduction of country-by-country reporting was advocated by the June 2009 Report of the Task Force on Financial Integrity and Economic Development, "Country-by-Country Reporting: Holding multinational corporations to account", which was discussed during the G20 meeting in Berlin in that same month.
17. The most recent example is the proposed introduction in the European Union of country-by-country reporting for the extractive industry and loggers of primary forest by changing the EU Accounting Directives. *See* press release of the Council of the European Union, 17 Apr. 2013, 8530/13 PRESSE 149.
18. Following the conclusion of negotiations between the Council, the Parliament and the European Commission, the European Parliament voted on 16 April 2013 to adopt the proposed text for CRD IV. The final text is still to undergo a review of legal drafting and translation into other official EU languages, and formal adoption by the Council. Provided that such translation is completed in time for the legislation to be published in the Official Journal before 1 July 2013, implementation of the CRD IV will be from 1 January 2014.
19. OECD, "Improving Access to Bank Information for Tax Purposes" (2000).
20. The OECD efforts in this area were given a boost by the Statement of the G20 Leaders following the summit of 2 April 2009 in London, in which they expressed their joint determination to change international practices by including the famous phrase "the era of banking secrecy is over".
21. Progress report to the G20 Finance Ministers and Central Bank Governors, *Global Forum Update on Effectiveness and Ongoing Monitoring* as included in the OECD Secretary-General's report to the G20 Finance Ministers, Apr. 2013.
22. Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, EU Law IBFD.

The main objective of the Savings Directive is to enable savings income in the form of interest payments made in one EU Member State, to beneficial owners who are individuals resident in another EU Member State, to be made subject to effective taxation in accordance with the laws of the latter state.[23] This is achieved through an automatic exchange of information on cross-border interest income. However, due to banking secrecy legislation, Austria and Luxembourg are currently still permitted to levy a withholding tax on the savings income of residents of other Member States, instead of exchanging information.

From its inception, there have been concerns about significant loopholes contained in the Savings Directive. The Commission is required to assess the directive's operation every three years, and, upon completing the first of its reviews, published a proposal to amend its scope in November 2008.[24] In particular, this proposal sought to improve on two major aspects, namely to (i) better ensure the taxation of interest payments which are routed through intermediate tax-exempted structures and (ii) extend the scope of the Savings Directive to financial products generating interest-like yields. A second EU Commission review completed in March 2012 reinforced these findings, but it has proved to be very difficult for Member States to reach unanimity as regards broadening the scope of the Savings Directive.[25]

3.2.3. FATCA: From a US initiative to a global standard?

The Foreign Account Tax Compliance Act (FATCA) is a US law aimed at foreign financial institutions to prevent tax evasion by US citizens and residents through the use of offshore accounts. To accomplish this objective, FATCA requires financial institutions to sign agreements with the IRS to report information regarding their US account holders to the IRS. If a foreign financial institution does not comply with the FATCA requirements, all relevant US-source payments, such as dividends and interest paid by US corporations, will be subject to a 30% withholding tax. The law was enacted in 2010 and will become effective as from 1 January 2014.

In February 2012, the governments of the United States, France, Germany, Italy, Spain and the United Kingdom released a joint statement[26] indicating that they would explore an alternative approach to FATCA implementation through the automatic exchange of information. On 26 July 2012, the US Treasury released two versions of a Model Intergovernmental Agreement for foreign governments interested in adopting this alternative FATCA regime.

On 9 April 2013, the same five EU Member States announced their plan to work on a pilot multilateral exchange facility using the model agreed with the United States as a basis.[27] The ultimate goal would be for this model to become the international standard. At the time of writing this article, Poland, the Netherlands, Belgium and Romania have also expressed their support of this initiative, and even Luxembourg announced that it will ease its banking secrecy laws.[28] With only Austria still refusing to share information on an automatic basis, it seems that the stalemate on revising the Savings Directive has finally been broken. It is expected that the European Union will increase the pressure on third countries, such as Switzerland, to follow suit.[29]

4. General Developments

4.1. Anti-money laundering legislation: 2007

The Financial Action Task Force (the Task Force) is the global standard-setter for measures to combat money laundering. The European Commission (the Commission) is one of the founding members of the Task Force and plays an active role in the various working groups and meetings.

The current EU legislation, the so-called Third Anti-Money Laundering Directive (the Third AMLD),[30] is based on the Task Force recommendations and has been operative since December 2007. It provides a European framework built around the international Task Force standards. The directive applies to banks and the whole of the financial sector, as well as to lawyers, notaries, accountants and other professional service providers. The directive requires these parties to identify and verify the identity of (the ultimate beneficial owners of) their clients and to monitor their transactions.

In February 2013, the EU Commission issued a proposal for a Fourth AMLD.[31] The proposed revised directive reinforces the rules on customer due diligence. Examples of transactions where enhanced due diligence will be required include those involving personal asset holding vehicles and cash-intensive businesses, those where unusual or apparently unnecessarily complex ownership structures are in place and those associated with certain "higher risk" jurisdictions. In addition, the directive expressly includes

23. For a general discussion on the functioning of the EU Savings Directive, *see* R. Offermans, *The Functioning of the EU Savings Directive: Strategies for Improvement*, 10 Derivs. & Fin. Instrum. 5 (2008), at 189-197, Journals IBFD.
24. Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, 13 Nov. 2008, COM(2008) 727 final.
25. In the meantime some countries, such as the United Kingdom, decided to tackle this type of evasion by concluding bilateral agreements with Switzerland which, controversially, preserve aspects of Swiss banking secrecy.
26. Joint Statement regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA (8 Feb. 2013).
27. For a copy of the letter, *see* http://www.hm-treasury.gov.uk/d/g5_letter_to_european_commission_090413.pdf.
28. It is striking that the sudden progress in this area was preceded by two highly publicized events. During the EU bailout negotiations with Cyprus in early 2013, it turned out that many foreign depositors were allegedly using the country for hiding so-called black money. Another scandal came to light in April 2013 when the International Consortium of Investigative Journalists published leaked information pointing to offshore accounts held by 130,000 prominent figures around the world (better known as "Offshoreleaks").
29. *See* e.g. T. Verhoosel, *Savings taxation – Switzerland Mounts Resistance*, Europolitics (15 Apr. 2013).
30. Directive 2005/60/EC of 26 Oct. 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, EU Law IBFD.
31. For more information, *see* http://ec.europa.eu/internal_market/company/financial-crime/index_en.htm.

"tax crimes" related to direct and indirect taxes in the definition of "criminal activity" in line with the most recent Task Force recommendations.

4.2. EU Directive on Improved Administrative Cooperation: 2011

On 15 February 2011, the Council adopted the new Council Directive 2011/16/EU on administrative cooperation in the field of taxation, which entered into force on 1 January 2013. The revised directive is aimed at strengthening administrative cooperation, especially via the exchange of information. The directive should ensure that the OECD standard for the exchange of information upon request is implemented in the European Union. It will thus prevent a Member State from refusing to supply information concerning a taxpayer of another Member State on the sole grounds that the information is held by a bank or other financial institution. The directive also sets out a step-by-step approach aimed at ensuring automatic exchange of information for eight categories of income and capital as from 1 January 2015: income from employment, directors' fees, dividends, capital gains, royalties, certain life insurance products, pensions, and ownership of and income from immovable property.[32]

4.3. OECD report on hybrid mismatches: 2012

In March 2012, the OECD published a report titled "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues".[33] The report deals with double non-taxation and long-term deferral of taxation resulting from the use of hybrids instruments, hybrid entities and transfers between two or more countries. The OECD recommends the introduction or revision of specific and targeted anti-avoidance rules, disclosure initiatives, and administrative assistance on "deterrence, detection, and response strategies". Although the report does not specifically discuss banks and financial institutions, it does mention as an example the well-publicized case of a NZD 2.2 billion tax settlement by four New Zealand banks on some structured finance transactions.[34]

It will be interesting to see how the OECD recommendations will be applied to Additional Tier 1 capital instruments issued by banks. The Basel III regulatory framework requires banks to raise more capital from the markets, and the instruments that they may issue need to have more equity-like features, increasing the likelihood of cross-border mismatches in tax treatment.[35]

4.4. OECD base erosion and profit shifting project: 2012

Backed by political support of the G8[36] and the G20,[37] the OECD recently initiated a new project on Base Erosion and Profit Shifting (BEPS). BEPS is defined as "tax planning strategies that exploit loopholes in tax rules to make profits disappear for tax purposes or to shift profits to locations where there is little or no real activity but where they are lightly taxed, resulting in little or no overall corporate tax being paid".[38]

As part of this project, the OECD recently published a background document[39] identifying certain "key pressure areas" for further work. Similar to the report on hybrid mismatches, the BEPS project has a general scope and does not include a specific discussion of planning techniques used by financial institutions or banks. However, the pressure areas that also could be of relevance to banks include:
- international mismatches in entity and instrument characterization;
- application of treaty concepts to profits derived from the delivery of digital goods and services;
- tax treatment of related-party debt financing, captive insurance and other intra-group financial transactions;
- transfer pricing, particularly in relation to the shifting of risks and intangibles; artificial splitting of ownership of assets between legal entities; and transactions between related entities that would rarely take place between independent entities;

32. On 6 Dec. 2012, the European Commission adopted a Regulation laying down detailed rules for implementing the new directive. *See* Commission Implementing Regulation (EU) 1156/2012 of 6 Dec. 2012 laying down detailed rules for implementing certain provisions of Council Directive 2011/16/EU on administrative cooperation in the field of taxation, EU Law IBFD.
33. OECD, "Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues" (2012). Other OECD publications in the area of aggressive tax planning – not further discussed by in this article – are: "Aggressive Tax Planning based on After-Tax Hedging" (2013), "Tackling Aggressive Tax Planning through Improved Transparency and Disclosure" (2011) and "Engaging with High Net Worth Individuals on Tax Compliance" (2009).
34. *Four Banks To Pay $2.2 Billion in Largest Ever Tax Settlement*, Ntl. Bus. Rev. (24 Dec. 2009).
35. The UK government recently announced that all additional Tier 1 debt capital will be deductible for UK tax purposes, yet does not seem to attach any relevance to the tax treatment of such instruments in the hands of the holder. *See* HM Treasury, Budget 2013, para. 2.117, at 81.
36. British Prime Minister David Cameron noted in his speech on 24 January 2013 at the World Economic Forum in Davos: "We want to use the G8 to drive a more serious debate on tax evasion and tax avoidance. This is an issue whose time has come. After years of abuse people across the planet are rightly calling for more action, and most importantly there is gathering political will to actually do something about it" (*see* https://www.gov.uk/government/speeches/prime-minister-david-camerons-speech-to-the-world-economic-forum-in-davos). One month later, German Chancellor Angela Merkel highlighted in her speech in the northern town of Demmin: "It's not right that giant global companies have huge sales here (in Germany), in all of Europe, in the United States and elsewhere and then only pay taxes somewhere in a tiny tax haven. That's why we're going to fight to finally put an end to tax havens at the G8 meeting this year in Great Britain". *See* German Chancellor Angela Merkel, speech of 13 Feb. 2013, http://www.reuters.com/article/2013/02/13/us-g20-tax-germany-merkel-idUSBRE91C1G020130213.
37. G20 Communiqué of 16 Feb. 2013 ("In the tax area, we welcome the OECD report on addressing base erosion and profit shifting and acknowledge that an important part of fiscal sustainability is securing our revenue bases. We are determined to develop measures to address base erosion and profit shifting, take necessary collective actions and look forward to the comprehensive action plan the OECD will present to us in July".). *See* Communiqué of Meeting of G20 Finance Ministers and Central Bank Governors, Moscow (16 Feb. 2013).
38. As defined in the Frequently Asked Questions section of the OECD website. *See* http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm.
39. OECD, "Addressing Base Erosion and Profit Shifting" (2013).

- effectiveness of anti-avoidance measures, CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse; and
- availability of harmful preferential regimes.

Currently, the OECD is drawing up a comprehensive action plan, developed in cooperation with governments and the business community, which will further quantify the corporate taxes lost and provide concrete timelines and methodologies for solutions to reinforce the integrity of the global tax system.

The BEPS project does not represent an immediate change in tax laws, tax treaties or tax administrative practices; instead it provides a window into fundamental international tax changes that are under consideration at the international and national level. It is important for multinational banks to closely monitor this project, as it appears that some governments are prepared to depart from longstanding international tax principles and deploy non-traditional approaches to achieve their budgetary goals.

4.5. EU action plan against tax fraud and tax evasion: 2012

The Commission is ahead of the OECD in releasing an action plan for addressing tax evasion and tax avoidance. The main objective of the action plan,[40] which the Commission published at year-end 2012, is to secure sustainable tax revenues for Member States by protecting tax systems against abuses and loopholes and, in particular, to reduce cross-border international tax fraud and tax avoidance affecting Member States' revenues. Concurrently, the Commission adopted two recommendations to the Member States calling for coordinated EU action on third countries not meeting minimum standards of good governance in tax matters and on aggressive tax planning.[41]

Most of the suggested initiatives concern an increase in the exchange of information and knowledge between the tax administrations of the Member States (e.g. the development of IT tools and joint tax audits). With respect to aggressive tax planning policy responses, the action plan reveals a pragmatic legislative approach to be undertaken at four levels. Apart from the traditional *EU legislative approach* (e.g. revision of the EU Parent-Subsidiary Directive (90/435) to tackle double non-taxation within the European Union in the area of hybrid loan structures),[42] the Commission proposes *national* enactment in all Member States of general anti-abuse rules (GAARs), as well as *bilateral* measures between Member States, for example the inclusion of a clause in Member States' tax treaties to prevent double non-taxation. Finally, the Commission proposes two soft law instruments, namely an EU Taxpayer's Code[43] and of a Platform for Tax Good Governance.

The legitimate question arises as to what can be expected of the EU initiatives. Currently, the Commission seems to favour convergence of Member State tax systems, rather than EU-wide harmonization of Member State corporate tax systems. This is probably because direct taxation falls within the competence of the Member States and is subject to unanimous decision-making. Even a revision of the Parent-Subsidiary Directive to prevent double non-taxation in the area of hybrid loan structures may therefore – politically speaking – not be a walkover. At the same time, one should not underestimate the momentum that these initiatives have created. The action plan finds its origin in a clear mandate from the European Council and the Parliament and therefore, is backed and monitored by the Member States themselves. Additionally, Member States obstructing sensible anti-avoidance legislation will be regarded with scorn. Finally, the action plan may well have a self-fulfilling effect on Member States' administrative practices.

Although the action plan is not specifically aimed at banks, it is clear that they too will be subject to the measures taken by the European Union as part of the action plan with respect to their own tax affairs. In addition, banks will be confronted with these measures when dealing with their clients. In view of the potential (reputational) risks that banks face when facilitating aggressive tax structures for their clients, a heightened scrutiny from regulators can be expected as regards client acceptance and on-going monitoring of the tax affairs of clients.

It is hoped that the Commission – during its preparation of upcoming proposals and initiatives – will take into account the impact of the policy responses of taxpayers. Currently, its main focus seems to be on the tax revenue that the EU policy responses could generate for Member States and on their compliance costs, rather than on the administrative and tax burden on the business community that would have to deal with these measures, especially in connection with the investment conditions within the European Union as compared to, for example, the United States or China.

40. Communication from the Commission to the European Parliament and the Council, "An Action Plan to strengthen the fight against tax fraud and tax evasion", COM(2012) 722 final, 6 Dec. 2012. For an extensive analysis of the action plan, *see* M.F. Nouwen, in *Highlights & Insights on European Taxation* 2013/1.3; R.A. de Boer & M.F. Nouwen, *Europees geschut tegen belastingparadijzen en agressieve fiscale planning: het vizier staat nog niet scherp*, WFR 2013/34.
41. Commission Recommendation regarding measures intended to encourage third countries to apply minimum standards of good governance in tax matters, C(2012) 8805 final, 6 Dec. 2012; Commission Recommendation on aggressive tax planning, C(2012) 8806 final, 6 Dec. 2012.
42. The Commission is also reviewing the anti-abuse provisions included in the Interest and Royalties Directive (2003/49), Merger Directive (90/434) and Parent-Subsidiary Directive (90/435), with a view to implementing the principles underlying the recommendation on aggressive tax planning. For further details, *see* European Commission, "Stakeholder meeting – Direct Taxation, A review of anti-abuse provisions in EU legislation", Working Paper (2013).
43. The Commission recently launched a public consultation on the development of a European Taxpayer's Code, which would clarify the rights and obligations of both taxpayers and tax authorities. The consultations will run until 17 May 2013. This consultation is connected to the current avoidance debate. The questionnaire raises the issue of whether general principles on information on possible measures to combat tax avoidance and evasion should be included in the Code. *See further* "Fighting evasion: Commission launches consultations on EU Taxpayer's Code and EU Tax Identification Number", European Commission press release, IP/13/154, (25 Feb. 2013). For further commentary, *see* M.F. Nouwen, in *Highlights & Insights on European Taxation* 2013/1.3.

4.6. EU code of conduct group on business taxation: 1998-2013

The EU Member States address harmful tax competition as far back as 1997. In that year the Member States agreed on a Code of Conduct for Business Taxation (the Code),[44] a political agreement to counter harmful policy competition in the area of business taxation. It is enforced by a group of high-level representatives of the Member States, the Code of Conduct Group on Business Taxation (the Code Group).[45] The work of this Code Group can be roughly subdivided into three problem areas, namely one-country issues, two-country issues and third-country issues.[46]

The most well-known working area concerns one-country issues.[47] Presently the work in this area consists of annually reviewing potentially harmful tax measures (including tax rulings) and rollbacks. Specifically for banks and other financial groups, it is worth noting that the Code Group recently agreed to begin examining special tax regimes for investment funds. The Code Group December 2011 Progress Report reads as follows:

> On the basis of cases provided by Member States and to the extent considered necessary the Group will examine policy responses available addressing potentially harmful tax planning by multinationals through the use of special tax regimes for investment funds possibly leading to a best practices solution.[48]

Although formally these special tax regimes already fall within the scope of the Code, to date the Code Group has not examined these types of regimes and other structures frequently used in the financial services sector. The reason for this is that, when preparing the blacklist with harmful tax measures in the late 1990s under the chairmanship of Dawn Primarolo, it was decided to leave these regimes aside "for the time being".[49] The definition of the proposed examination is broadly formulated and therefore rather vaguely defined. It seems to indicate that it would not target a *formal assessment* of the tax regimes of Member States for investment funds against the five criteria of the Code (i.e. blacklisting), but concerns rather a more general examination of these regimes. This is also evident from the Code Group June 2012 Progress Report, which notes that Member States learned from achievements by and experiences of the United Kingdom on harmful tax planning through the use of special tax regimes for investment funds.[50] The discussions on this topic, which have just begun, could lead to an agreement on a best practice solution that could contribute to a certain level of coordination regarding the conditions for special tax regimes for investment funds in the various Member States. This should prevent the regimes from being improperly used for unintended purposes.[51]

Additionally, in the past couple of years the Code Group has increasingly focussed on so-called two-country issues. The concrete results achieved to date in this area are limited to mismatches between national law characterizations of payments made under hybrid loan arrangements. In order to tackle this issue, the Code Group agreed that the recipient Member State should adapt taxation of hybrid payments to the tax treatment in the source Member State. The Code Group May 2010 Progress Report reads as follows:

> In as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption.[52]

This means that no tax exemption should be granted for payments that are deductible by the foreign debtor. The Code Group is still debating the implementation of this *agreed guidance*; no consensus seems to exist yet on the form of implementation (i.e. hard law or soft law). However, the EU action plan and very recent consultation papers of the Commission reveal that the Commission is pushing for the hard-law approach by amending the Parent-Subsidiary Directive.

In a recent discussion paper,[53] the Commission underlines that the politically agreed guidance of the Code Group clashes with the obligation contained in the Parent-Subsidiary Directive. Indeed, the way the Parent-Subsidiary Directive is currently drafted obligates the recipient Member State to exempt profit distributions irrespective of the tax treatment of the hybrid payment in the source Member State. Although several Member States had doubts or did not agree with this view, most of the Member States seem to support or do not oppose a targeted amendment of the Parent-Subsidiary Directive to remove the barrier to the effective implementation of the agreed guidance.

The legislative amendment currently proposed by the Commission would be construed as a clarification of the scope of the Parent-Subsidiary Directive and as a targeted carve-out clause. The Commission proposes two alternative policy options on the form of such carve-out clause:

44. Annex 1, "Resolution of the Council and the Representatives of the Governments of the Member States, Meeting Within the Council of 1 December 1997 on a Code of Conduct for Business Taxation" to the Council conclusions of 1 Dec. 1997 concerning Taxation Policy (98/C 2/01), OJ C98 (6 Jan. 1998).
45. Council conclusions of 9 Mar. 1998 concerning the establishment of the Code of Conduct Group (Business Taxation), 98/C 99/01, OJ C99 (1 Apr. 1998).
46. Third-country issues concern the dialogue between the EU and third countries, especially Liechtenstein and Switzerland, on the application of the principles and the criteria of the Code on Conduct. Further consideration of this issue is beyond the scope of this article.
47. Initially this involved blacklisting and the rollback of individual Member States' harmful tax measures. Rollback means phasing out harmful tax measures. To date, more than 100 national tax measures have been removed or amended after having been labelled as harmful by the Group.
48. Code of Conduct Group Progress Report of 13 Dec. 2011, Work Package 2011, 17081/1/11 REV 1, LIMITEE FISC 144, at 8.
49. Code of Conduct Group Progress Report of 23 Nov. 1999, SN 4901/99, para. 28, at 10.
50. Code of Conduct Group Progress Report of 11 June 2012, 10903/12, LIMITEE FISC 77, para. 22.
51. For further commentary on this topic, *see* Comments by M.F. Nouwen on Code of Conduct Group Progress Report of 21 Dec. 2011 and of 22 June 2012, in Highlights & Insights on European Taxation 2012/2.1 and 2012/8.3, respectively.
52. *See* Code of Conduct Group Progress Report of 25 May 2010, doc. 10033/10, para. 12.
53. *See* European Commission, "Stakeholders' Consultation, Amendment of the Parent-Subsidiary Directive to ensure that the application of the Directive does not inadvertently prevent effective action against double non-taxation in the area of hybrid loan structures", Discussion Paper (27 Mar. 2013).

- option 1: payments of distributed profits which are deductible in the source Member State *would be excluded from the benefits of the PSD*; or
- option 2: payments of distributed profits which are deductible in the source Member State *would be excluded from the benefits of the tax exemption*.

Option 1 would enable the Member State of the parent company to deny the benefits of the Parent-Subsidiary Directive to distributions of profits that are deductible by the subsidiary. So although the receiving Member State is not obligated to ensure the benefits of the Parent-Subsidiary Directive to hybrid loan arrangements, it remains up to *political will* of each Member State to adapt their national tax legislation to the agreed guidance.

In contrast, option 2 aims to legally solve the double non-taxation issue by mandatorily providing for the taxation of payments deductible in the source Member State. This policy option would *legally oblige* the Member State of the parent company to deny the benefits of the tax exemption to distributions of profits that are deductible by the subsidiary.

As an amendment of the Parent-Subsidiary Directive is subject to unanimous decision making in the Council, it remains to be seen when and which of the policy options will be chosen. Further, it should be noted that although the proposed amendment would, either politically or legally, seem to solve the double non-taxation issue in the area of hybrid loan structures between EU Member States, the issue remains at least partially unresolved in relation to third countries. This is specifically the case in EU outbound situations when a recipient third state treats the payments under a cross-border hybrid loan as a tax-exempt distribution of profits while a source EU Member State grants an interest deduction for the debtor. One should note that interest deduction in the source EU Member State is not denied based upon the agreed guidance, nor based upon one of the proposed Parent-Subsidiary Directive amendments. Finally, the question arises how the European Union will deal with EU inbound situations. It remains to be seen whether all Member States will deny tax exemption in relation to third countries in respect to hybrid loan payments, as the Parent-Subsidiary Directive concerns the tax treatment of profit distributions between parent companies and subsidiaries of different EU Member States and therefore does not apply to profits distributed from third countries.

Recently, the Code Group also turned to other mismatches. The Code Group December 2012 Progress Report shows that hybrid entities (fiscally transparent in one Member State, while a fiscal entity in the other) and hybrid permanent establishments are priority areas for future work.[54] This makes sense, as through hybrid entities a similar effect can be achieved as via hybrid loan arrangements. Detailed technical discussions on these issues are currently ongoing.

54. *See* Code of Conduct Group Progress Report of 23 Nov. 2012, 16488/12, LIMITEE FISC 173, para. 12.

5. Conclusion

Rarely have advocacy groups, tax administrators, tax policy-makers and the public in general been in such agreement: a dramatic convergence of trends has created a burning platform with a view to combating aggressive tax structures. The developments of the last 12 months have accelerated the awareness that the piecemeal approaches applied so far have not sufficiently paid off.

The international drive towards automatic exchange of tax-related information is gaining momentum fast. Banks will have to ensure that their processes and systems are able to handle the increasing requirements. Where necessary, US FATCA implementation programmes will need to be adjusted in order to accommodate compliance with an emerging international standard. Moreover, banks are increasingly expected to identify, monitor and report aggressive tax planning structures used by their clients. This "tax audit function" imposed on banks worries the authors. It could effectively amount to a delegation of public duties and responsibilities to the private sector, which could undermine governance, accountability and legitimacy of the public sector. Finally, as there is no clear dividing line between aggressive and regular tax planning, it will be very challenging for banks to determine the specific changes to be made to their customer due diligence processes.

It is a well-known fact among international tax practitioners that the heydays of bank-initiated tax-driven structured finance transactions are long gone. Banks in various EU countries have (either informally or formally) signed on to "cooperative compliance agreements" and "enhanced relationship programs", or have committed themselves to a Code of Conduct in tax matters. Many banks have implemented more robust internal standards for tax planning and have downsized or completely eliminated their departments that engaged in tax-driven structuring.[55] Sometimes these changes have not been completely "voluntary"; especially banks that have become state-owned after having been bailed-out by the national government have found that they are now being held to higher ethical standards than they were used to. In addition, as many banks have seen their tax capacity wiped out by the financial crisis, they had no real choice but to change their behaviour in this area.

55. A recent example is the Strategic Review undertaken by Barclays PLC that also resulted in the adoption of new Tax Principles. *See* the speech of A. Jenkins, Barclays PLC Strategic Review, 12 Feb. 2013, at http://group.barclays.com/Satellite?blobcol=urldata&blobheader=application%2F-pdf&blobheadername1=Content-Disposition&blobheadername2=MDT-Type&blobheadervalue1=inline%3B+filename%3DAntony-Jenkins-speech-12-February-2013-PDF-1230.pdf&blobheadervalue2=abinary%3B+charset%3DUTF-8&blobkey=id&blobtable=MungoBlobs&blobwhere=1330696688918&ssbinary=true.

Those banks that have already "de-risked" their tax profile should not be impacted significantly by the most recent EU and OECD efforts on hybrid mismatches and base erosion and profit shifting. Their challenge in this area will centre around *communication*. Banks will be at the forefront of the trend towards increased transparency on tax matters. In order to regain the trust of citizens in the financial sector, they will need to consider their tax policies as part of their overall corporate responsibility strategy. It will often be a challenge to explain to the general public seemingly strange discrepancies between book profits and taxes paid in a particular country. But instead of disclosing the bare minimum as required by country-by-country reporting regulations, best practices will develop. Some banks will embrace tax as an integral component of their corporate social responsibility report and may even use it as a marketing tool to distinguish themselves from the competition.[56]

56. For an extensive analysis of the relationship between corporate responsibility and tax, *see* J.A.R. van Eijsden, *The Relationship between Corporate Responsibility and Tax: Unknown and Unloved*, EC Tax Rev. 1 (2013), at 56-61.

Jan Grabbe, Marco Simonis and Stefan Behrens*

Draft Legislation Amending Germany's Investment Tax Law in Line with the AIFM Directive

On 30 January 2013, the German federal cabinet approved the bill amending the German Investment Tax Act reflecting the draft Capital Investment Act which transposes the EU Alternative Investment Fund Managers Directive into German law. If not an "investment fund", a collective investment undertaking might be classified as an investment corporate vehicle or as an investment partnership, each of which is subject to a separate tax regime. This article provides an overview of the changes which are due to take effect on 22 July 2013.

1. Introduction

On 30 January 2013, the German federal cabinet approved the bill amending the German Investment Tax Act (the bill).[1] The bill will reflect the draft Capital Investment Act[2] which transposes the EU Alternative Investment Fund Managers Directive (AIFM Directive)[3] into German law. The bill follows the draft bill published by the German Federal Ministry of Finance on 4 December 2012 (the Ministerial Draft) with some changes. On 22 March 2013, the Second Chamber[4] requested certain changes to the bill and asked for further investigation of certain issues, to which the German federal government responded on 28 March 2013. This article provides an overview of the changes which are due to take effect on 22 July 2013.[5]

One beneficial aspect of the bill is that any funds that are covered by the Investment Tax Act under existing legal provisions and have been launched before 22 July 2013 will be grandfathered without limitation as to time. The Second Chamber has requested to limit this grandfathering until the end of the first fiscal year ending after 22 July 2014.[6]

For any other funds, i.e. funds which are not covered by the current Investment Tax Act and for funds launched after 21 July 2013, a new classification with new tax regimes will apply according to the bill. One of three tax regimes will apply to such funds. Alongside the tax regime that applies under the current Investment Tax Act (so-called "limited transparency principle") and a tax regime for so-called "investment partnerships", a third regime for so-called "investment corporate vehicles" has been created. The proposal made in the Ministerial Draft that investors in such investment corporate vehicles would be subject to a disadvantageous flat-rate taxation will be subject to a legal review according to the bill, but has not been included in the bill.[7] Investors in investment corporate vehicles would instead, principally, be subject to the same tax regime as investors in standard corporate vehicles; however, exceptions do apply to commercial investors in investment corporate vehicles if the investment corporate vehicle is exempt from taxation or subject to a low tax rate.

2. New Investment Tax Act Regime

Subject to the grandfathering provisions,[8] the bill creates two main categories of funds, namely investment funds and investment enterprises:

– investment funds (*Investmentfonds*) include any undertakings for collective investment in transferable securities (UCITS) and any alternative investment funds (AIFs)[9] which meet specific criteria set out in the amended Investment Tax Act (tax criteria); and
– the new category investment enterprises (*Investitionsgesellschaften*) covers AIFs which do not meet one or more of such tax criteria.

The draft Capital Investment Act includes a definition of "AIF" which follows article 4, paragraph 1(a) of the AIFM Directive, according to which:

> AIFs means collective investment undertakings, including investment compartments thereof, which:
> (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

* **Clifford Chance, Frankfurt am Main.**

1. Bill of the German federal government, BR-Drs 95/13 (8 Feb. 2013).
2. Bill of the federal government for an Act on the Transformation of Directive 2011/61/EU on Alternative Investment Fund Managers, BT-Drs 17/12294 (6 Feb. 2013). Article 1 of this bill contains the draft Capital Investment Act.
3. Directive 2011/65/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009//65/EC and Regulations (EC) 1060/2009 and (EU) 1095/2010, Official Journal of the European Union, L 174/1 (1 July 2011).
4. *Bundesrat*.
5. *See* section 22, paragraph 1 of the draft Investment Tax Act as contained in the bill. Under article 66 Directive 2011/61/EU on alternative investment fund managers (AIFM Directive), the EU Member States must adopt and publish the laws, regulations and administrative provisions necessary to comply with the AIFM Directive by 22 July 2013. The German legislature envisages the adaptation of the German investment tax law as per the same date; *see* the bill amending the German Investment Tax Act to reflect the draft Capital Investment Act of 30 Jan. 2013 (the bill), article 11.
6. BR-Drs 95/13 (22 Mar. 2013), at 8, item 6.
7. In BR-Drs 95/13 (22 Mar. 2013), at 8, item 5, the Second Chamber has insisted on the need of a flat-rate taxation.
8. *See* section 3.
9. The term "AIF" is defined in article 4, paragraph 1(a) AIFM Directive.

(ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC.[10]

Under section 1, paragraph 1 of the draft Capital Investment Act, the term "investment fund" means every undertaking for collective investment which raises capital from a number of investors[11] in order to invest it in accordance with a fixed investment strategy to the benefit of those investors and which is not an operating enterprise outside the financial sector.

None of these criteria has so far been clearly defined. The Consultation Paper ESMA/2012/845 aims at clarifying certain of the criteria for a vehicle to be qualified as a "collective investment undertaking".[12]

Certain investment vehicles are exempt from the scope of the Capital Investment Act, including several types of holding companies, occupational pension funds and similar arrangements, the European Central Bank, national central banks, public social security and pension bodies, employee participation arrangements or savings schemes, and banks and financial services providers with the relevant licence.[13] According to the bill, these exceptions also apply for tax purposes.[14]

The exception provided for in the draft Capital Investment Act for those AIFM only managing AIFs in which only that AIFM, or any of its parent, subsidiary or sister companies, invests[15] does not apply for tax purposes, meaning that group-managed AIFs are still governed by the provisions of the Investment Tax Act.

As to the tax consequences and the applicable tax regime, the following applies.

Investment funds (i.e. UCITS and qualifying AIFs) systematically replace the category of domestic and foreign investment funds as defined in the current law. Under the limited transparency principle applicable to investment funds and their investors, in simple terms, earnings at the fund level are determined (so-called fund tax reporting) and allocated to the investors at the end of the year or when profit distributions are made, with their specific tax attributes being retained. While the Investment Tax Act currently still uses the concept of domestic and foreign investment funds as defined for regulatory purposes, the bill sets out a list of tax criteria which are independent from the draft Capital Investment Act and which are more restrictive in certain areas. For more information, see section 4.1.

The new investment enterprises (i.e. non-qualifying AIFs) and their investors are subject to a different tax regime, depending on the non-qualifying AIF's legal form:

– Investment corporate vehicles (*Kapital-Investitionsgesellschaften*)[16] pay trade tax and corporate income tax on their income, i.e. the general rules apply in this regard. According to the Ministerial Draft,[17] investors holding shares in such investment corporate vehicles were due to be subject to a penalty tax with the fictitious tax base based on the penalty tax which applies under the current regime if a fund does not comply with the tax reporting obligations.[18] However, crucially, it was not possible under the Ministerial Draft to prevent the application of such penalty taxation by complying with reporting obligations or in any other way. The penalty taxation has been heavily criticized and the bill no longer provides for the penalty taxation. Instead, investors in investment corporate vehicles will be subject to the same rules as investors in standard companies and corporations. In the case of commercial investors, an exception will apply to dividends or proceeds from the sale of shares in investment corporate vehicles if the respective investment corporate vehicle is tax exempt or only taxed at a low rate in its home country.[19] For more information on this concept and the tax consequences, *see* section 4.2.1.
– Investment enterprises organized as partnerships are referred to as "investment partnerships" (*Personen-Investitionsgesellschaften*). The provisions applicable to standard partnerships also apply to investment partnerships and their investors (including joint and separate declarations).[20] For details on this definition and its consequences, *see* section 4.2.2.

If a fund ceases to qualify as an investment fund and, therefore, is to be regarded as an investment enterprise,[21] the

10. Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investments in transferable securities (UCITS), Official Journal of the European Union L 302/32 (17 Nov. 2009), EU Law IBFD.
11. The investment terms, the articles or the partnership agreement of the undertaking for collective investment may not limit the number of potential investors to one investor; *see* section 1, paragraph 1, sentence 2 draft Capital Investment Act. Pursuant to the Consultation Paper ESMA/2012/845, Annex V, marginal note 15, limitation to one investor will not be deemed to exist if the sole investor acts on behalf of more than one investor, as – pursuant to ESMA – in the case of nominee arrangements, feeder structures and fund-of-funds-structures.
12. Pursuant to Consultation Paper ESMA/2012/845 (guidelines on key concepts of the AIFM Directive) (19 Dec. 2012), at 51, section VI. 9., the following characteristics, if all of them are exhibited by an undertaking or an investment compartment thereof, should indicate that the undertaking is a collective investment undertaking mentioned in article 4, paragraph 1(a) of the AIFM Directive. The characteristics are that the undertaking:
    – is not an ordinary company with a general commercial purpose;
    – pools together capital raised from its investors for the purpose of investment with a view to generating a *pooling return* for those investors from investments (whether or not different investors receive returns on different bases); and
    – the unitholders or shareholders of the undertaking have no day-to-day discretion or control over the management of the undertaking's assets.

    Under section VI. 10., the determination of the above characteristics indicating that an undertaking is a collective investment undertaking should be without prejudice to the fact that competent authorities and market participants should not consider that the absence of all or any one of them conclusively demonstrates that the undertaking is not a collective investment undertaking.
13. Sec. 2, para. 1 draft Capital Investment Act.
14. Sec. 1, para. 1a draft Investment Tax Act within the meaning of the bill.
15. Sec. 2, para. 3 draft Capital Investment Act.
16. For the exact definition, *see* below.
17. Sec. 19, para. 2 draft Investment Tax Act in the form of the Ministerial Draft.
18. Sec. 6 Investment Tax Act.
19. Sec. 19, para. 2 draft Investment Tax Act in the form of the bill.
20. Sec. 18 draft Investment Tax Act in the form of the bill.
21. Such a change of an investment fund into an investment enterprise occurs if an investment fund amends its investment conditions in a way that the tax criteria are no longer fulfilled, or if the investment fund commits a

investment share is deemed to have been sold at fair market value and a share in an investment enterprise is deemed to have been purchased;[22] payment of the tax determined on the fictitious capital gain is deferred without interest until the share has actually been sold.[23] The investment enterprise may change back into an investment fund only after the lapse of three years.

If an investment enterprise ceases to qualify as an investment enterprise and fulfils the tax criteria so that it qualifies as an investment fund,[24] the share in the investment enterprise is deemed to have been sold at fair market value and a share in an investment fund is deemed to have been purchased;[25] payment of the tax determined on the fictitious capital gain is deferred without interest until the share has actually been sold.[26] If the undertaking for collective investment previously changed from an investment fund into an investment enterprise, the three-year period must be observed.

3. Grandfathering Clause for Investment Funds Falling under the Current Investment Tax Act

Grandfathering rules will apply to funds which are regarded as domestic or foreign investment funds under existing legal provisions, i.e. under the Investment Tax Act, and these will continue to be governed by the limited transparency principle if they have been or will be launched prior to 22 July 2013.[27]

This grandfathering provision relates exclusively to the issue of whether or not the fund and/or the fund shares may be regarded as being investment funds or investment shares under the Investment Tax Act as applicable on 21 July 2013. This means that any investor acquiring units after 21 July 2013 in a grandfathered fund will also benefit from the grandfathering provision. Further, the grandfathering applies irrespective of the time investments are made by the fund. The bill does not include any time limits.[28] In the case of umbrella funds, the launch date of the relevant subfund will be decisive. The (minimum) requirements for launching a fund will evolve from future discussions among the interested parties.

If the grandfathering clause applies to a specific fund, the tax regime applicable to it and its investors will not change, even if the fund no longer qualifies as an investment fund under the Investment Tax Act as applicable from 22 July 2013 (as it does not, or does from a certain future point in time no longer, meet the tax criteria set out in the bill). The fund and its investors will still be taxed under the restricted transparency principle. Certain aspects of this principle are due to be amended.[29]

The grandfathering provision will cease to apply when the investment fund no longer meets the requirements under the Investment Tax Act as applicable on 21 July 2013.

Funds not covered by the existing Investment Tax Act are not covered by the grandfathering clause. This means that investors in certain funds (in the terms of the Ministerial Draft and of the bill, investment corporate vehicles) may not rely on certain tax reliefs which generally apply to dividends and sale proceeds in future.[30]

4. New Classifications

4.1. Investment funds

The new investment funds category, to which the limited transparency principle will apply, includes:
- all UCITS; and
- any AIFs satisfying the following tax criteria:[31]
  - subject to investment supervision;
  - providing for a right of redemption (at least once a year) or trading on a stock exchange within the meaning of the German Stock Exchange Act;
  - objective: investment/management on behalf of investors, but no active management/influence (with the exception that management of real estate by real estate companies is permitted);
  - level of risk diversification: at least four assets conferring different risks, where target funds may be subject to a look-through approach;
  - no more than 20% of the total value of the AIF is invested in unlisted participations and less than 10% of all shares issued are acquired by the AIF. These restrictions do not apply to any holdings in real estate companies;
  - loans: short-term loans only up to 30% of the total value of the AIF. Under a special provision for real estate funds, no more than 30% short-term loans and leverage of up to 50% of the current property values;
  - at least 90% of the total value of the AIF must be invested in certain eligible assets, namely: securities, money market instruments, derivatives, bank deposits, property, rights equivalent to property and comparable rights under the laws of other countries (as well as fixtures required to manage real estate), real estate companies as defined in section 1, paragraph 19, no. 22 of the draft Capital Investment Act, units in German

material breach of the tax criteria. Sec. 1, para. 1d draft Investment Tax Act in the form of the bill.

22. Sec. 1, para. 1d and Sec. 8, para. 8 draft Investment Tax Act in the form of the bill.
23. Sec. 8, para. 8, sentence 7 draft Investment Tax Act in the form of the bill.
24. Such a change into an investment fund occurs if the investment enterprise amends its investment conditions and changes its actual investment activities in a form such that the tax criteria are fulfilled.
25. Sec. 20 draft Investment Tax Act in the form of the bill.
26. Sec. 20, sentence 7 draft Investment Tax Act in the form of the bill. Pursuant to the legislative reasoning of the bill, a breach of the investment thresholds which is due to an increase or decrease in value of assets will not be regarded as a material breach; material breaches will only result from active transactions. BR-Drs 95/13 (9 Feb. 2013), at 35.
27. Sec. 22, para. 2 draft Investment Tax Act in the form of the bill.
28. The Second Chamber has requested a limitation until the end of the first fiscal year ending after 22 July 2014. BR-Drs 95/13 (22 Mar. 2013), item 6, at 9 et seq. According to the Second Chamber, in case of a transition period ending at the end of the first fiscal year ending after 22 July 2014, investment funds would have sufficient time to carry out the required adjustments.
29. *See* section 4.1. at the end.
30. *See* section 4.2.
31. Sec. 1, para. 1b draft Investment Tax Act in the form of the bill.

investment funds, EU investment funds and foreign investment funds, public-private partnerships, precious metals, non-securitized loan claims and participations where the market value of these can be determined; and
– investment guidelines/articles of association include the above requirements.

The fact that these requirements (i.e. the tax criteria) are set out independently in the Investment Tax Act means that the scope of the limited transparency principle is no longer linked to the supervisory law. The list is, in some respects, more restrictive compared to the current scope, particularly compared to the current definition of foreign investments funds.

The main differences are as follows:
– in future, both investment supervision and a right of redemption (or, alternatively, trading on a stock exchange) will be required. Under the current definition, it is sufficient for a foreign fund either to be subject to supervision or to make provision for a right of redemption;
– the tax criteria demand for the first time that holdings in corporations or companies (except for real estate vehicles in corporate form) be limited (to less than 10% of all shares issued). The current legal provisions do not specify any corresponding restrictions for specialized funds;
– contrary to the current definition of "foreign investment fund" (and subject to the special provisions for real estate funds), the tax criteria limit short-term loans to 30% of total fund assets; and
– some of the dramatic changes that had originally (in the Ministerial Draft) been envisioned for real estate funds have been removed or watered down. The original intention to limit indirect real estate investments (via property or holding companies) to 49% of the fund's holdings has been dropped. The leverage limits for investment purposes to 30% of the current property values and for short-term loans to 10% of the total fund assets have been retained, but the limits have been raised to 50% and 30%, respectively. The current definition of "foreign investment fund" does not impose any leverage limits (although restrictions may arise under the German Insurance Supervisory Act). In order to establish risk diversification, a look-through approach applies to investments via target funds. However, there is still no corresponding provision for investments made via real estate companies.

Under the bill, in particular the following funds and their investors would no longer be taxed in line with the limited transparency principle if they are not covered by the grandfathering provisions:
– closed and semi-open-ended funds (without any trading on a stock exchange);
– funds investing via investment vehicles (which are not investment funds themselves);
– hedge funds taking out loans other than on a short-term basis; and
– real estate funds if they use leverage of more than 50% of their total value or make investments through less than four real estate companies).

The proposals set out in the bill, which effectively restrict the scope of the limited transparency principle, are not convincing in the authors' opinion. A specific administrative practice has developed around the current definition of funds, and the legal certainty that could be achieved over the years would be abandoned without any apparent need. The easing of some of the restrictions contained in the Ministerial Draft, particularly those relating to real estate funds, is to be welcomed, but there are still other changes which need to be made in various areas (specifically as regards the look-through approach for real estate companies).

The bill does not propose any amendments to the following provisions, despite the fact that objections were raised that they infringe the EU's basic freedoms. It remains the case that only domestic investment funds will be exempt from German corporate income tax and trade tax, which means that other EU investment funds are still treated less favourably. In addition, German investors receiving German dividends via non-German EU investment funds will continue to be subject to a higher tax burden in many cases than if they invested via a domestic investment fund.

The tax regime applicable to investment funds and their investors will be amended as follows:

– As was the case in the Ministerial Draft, it is proposed that all indirect fund costs will, in general, be tax deductible (and not just 90% like under current law). However, under the bill, such indirect fund costs will be allocated not only to current income but also to capital gains.[32] In many cases, particularly in the case of funds retaining their earnings, this will temporarily increase taxable income of the investors.

– In 2009, the German tax authorities set out rules as to the sources (income, capital) that are deemed to be used when a fund makes a distribution and as to the applicable order.[33] These rules will now be set out in the law.[34] Any earnings will initially be used to fund distributions before resorting to deemed distributions from previous years and, as a last resort, capital. The only exception relates to capital distributions made by real estate funds resulting from depreciation of properties. The bill differs from the Ministerial Draft in that it contains a simplified procedure for interim distributions. This allows investment funds to use deemed distributions from previous years to make interim distributions.

– There are methods which may be applied in practice allowing fund income to be "brought forward" via the disposal of bond coupons (bond stripping) and be allocated to investors. Such techniques may be used to

32. Sec. 3 draft Investment Tax Act in the form of the bill.
33. No. 16 Official Circular on the application of the Investment Tax Act of 18 Aug. 2009.
34. Sec. 3a draft Investment Tax Act in the form of the bill.

set off any investor losses which otherwise would have been affected by a loss offset barrier. The bill combats this by treating the separation into interest coupons and principal as an act of disposal and purchase, so that a part of the acquisition costs is allocated to the interest coupons.[35]

4.2. Investment enterprises

The new category of investment enterprises includes "non-qualifying" AIFs, which are those AIFs that are not grandfathered and do not meet one or more of the tax criteria for qualifying as an investment fund set out in section 4.1. This new category generally includes private equity funds, infrastructure funds, funds investing in renewable energy (e.g. solar, wind) and real estate funds which do not qualify as investment funds, for example because they do not grant a right of redemption. These investment enterprises are classified as either investment corporate vehicles or as investment partnerships.[36]

4.2.1. Investment corporate vehicles

Any AIF which is not grandfathered, does not meet the tax criteria for investment funds and is not structured as a German investment limited partnership under the draft Capital Investment Act or in a comparable foreign legal form will be regarded as an investment corporate vehicle. This includes any non-qualifying AIF organized as a German investment stock corporation (*Investmentaktiengesellschaft*) under the Capital Investment Act, as a Luxembourg SICAV S.A. or as a Luxembourg *fonds commun de placement* (FCP). This also includes any legal forms that AIFs may take which are not available under the Capital Investment Act, such as German private limited liability companies, partnerships limited by shares or "standard" stock corporations and comparable foreign legal forms. No specific grandfathering provisions apply to investors in investment corporate vehicles. The only investors enjoying protection are those investing in funds launched prior to 21 July 2013 under the Investment Tax Act applicable until then.[37]

Investment corporate vehicles would be subject to taxation at the fund level:

- German contractual-type funds are regarded as corporate vehicles or legal persons (in accordance with the current fiction).[38] However, German contractual-type funds and investment stock corporations not meeting the tax criteria for investment funds are not exempt from corporate income tax or trade tax.
- Foreign AIFs with legal forms "comparable" to German contractual-type funds (such as Luxembourg FCPs) are classified as opaque corporate vehicles under the Ministerial Draft and under the bill (and not as transparent). This issue had previously been the subject of considerable dispute. It will mean that foreign contractual-type funds like Luxembourg FCPs will be subject to German corporation tax on German-source income (i.e. such income will not be directly attributed to their investors) and to German trade tax on income they may generate via a permanent establishment in Germany, just like a Luxembourg SICAV S.A.

The following applies to German investors in investment corporate vehicles:

- Under the Ministerial Draft, German investors would have been subject to a disadvantageous penalty taxation, but without the possibility of the fund to prevent such penalty taxation by complying with reporting or other obligations. Domestic investors would have been required to pay tax each year on all distributions and on 70% of the increase of the last annual redemption price (or market/stock market price) compared to last year's redemption price, but at least on 6% of the final redemption price (based on the fiscal year, if known). This penalty taxation, which effectively represents a tax on capital in those years where insufficient profits are generated and which would have forced certain products off the market, has been criticized from a constitutional and regulatory perspective. Fortunately, the bill no longer pursues the penalty tax approach. However, the Second Chamber has requested that the penalty tax be reconsidered "in order to avoid permanent tax-neutral retention of profits".[39]
- In terms of the taxation of investors in investment corporate vehicles, the bill makes a distinction between private and commercial investors:
  - any distributions made by investment corporate vehicles and any corresponding capital gains received by German private investors are subject to income tax at the flat tax rate (25%).[40] Hence, such income is taxed in the same way as the respective income from standard corporate vehicles;
  - special rules may apply to commercial investors. The effective 40% exemption from income tax[41] and 95% exemption from corporate income tax for distributions and similar capital gains[42] will not apply if the investment corporate vehicle is not subject to, or is exempt from, tax on earnings (if based in the European Union or EEA) or if it pays less than 15% tax on earnings (if based outside the European Union and EEA). This marks a change compared to the existing legal situation; and
  - all types of investor are still potentially subject to taxation under the CFC rules, whereby certain passive and low-taxed income from foreign

35. Secs. 18 and 19 draft Investment Tax Act in the form of the bill.
36. *See* sections 4.2.1. and 4.2.2.
37. Sec. 22, para. 2 InvStG-E.
38. Sec. 11 InvStG.
39. BR-Drs 95/13 (22 Mar. 2013), at 8 item 5.
40. So-called *Abgeltungsteuer*.
41. Sec. 3, no. 40 German Income Tax Act.
42. Sec. 8b, paras. 1 and 2 German Corporate Income Tax Act.

companies and corporations is subject to tax in Germany.

The current proposal is much less drastic than the penalty taxation proposed by the Ministerial Draft, but is still problematic:

– Private equity funds, infrastructure funds, funds investing in renewable energy (e.g. wind, solar) and real estate funds not regarded as investment funds often invest indirectly in or via target companies, project companies or property companies which are subject to tax in the country where the investment is made. As the fund's income has already been taxed once, in the authors' opinion, the 40%/95% tax exemption should be applied to commercial investor to mitigate or avoid any double taxation.
– It is difficult to fathom why commercial investors should be subject to different tax regimes, depending on whether they invest in a specific AIF or a "standard" company or corporation. Such a different treatment may also raise concerns as to whether these rules are in line with German constitutional law.

4.2.2. Investment partnerships

Any AIF that is not grandfathered, does not meet the tax criteria for investment funds and is structured as an investment limited partnership or in a comparable foreign legal form will be regarded as an investment partnership. Such investment partnerships may be subject to trade tax at the fund level in accordance with the general conditions.

The provisions applicable to investors in "ordinary" partnerships are also applicable to investors in investment partnerships, i.e. the income of investment partnerships is also attributed to, and taxed in the hands of, its investors.

4.3. New German open-ended investment limited partnership

The draft Capital Investment Act introduces a new structure for open-ended investment funds set up in Germany, namely the German open-ended investment limited partnership (*offene Investment-KG*).[43] The aim is to create a transparent and attractive investment vehicle for pension asset pooling for international groups of companies.

Based on the draft Capital Investment Act, German open-ended investment limited partnerships must diversify their investments and have a reasonably flexible investment horizon,[44] allowing a certain degree of flexibility. They are open to professional and semi-professional investors.[45]

The tax regime for German open-ended investment limited partnerships depends on whether they qualify as investment funds in accordance with the list of tax criteria set out in section 4.1.

Some of these tax criteria will be met by any German open-ended investment partnership because of its regulatory framework under the draft Capital Investment Act, in particular supervision, annual right of redemption, risk diversification and typically also "passive" investment activities. Additional requirements must be met, however, in order for them to qualify as investment funds, including limits on investments in unlisted companies, leverage and eligible assets. The number of investors (which may not be natural persons) specified in the articles of association must be limited to 100.

The following applies to German open-ended investment limited partnerships qualifying as investment funds and their German investors:[46]

(1) Such German open-ended investment limited partnerships are exempt from trade tax. This means that no tax on income applies at the level of such German open-ended investment limited partnerships. However, because of the fund's exemption from trade tax, income from German open-ended investment limited partnerships is not exempt from trade tax at the investor level.[47]

(2) German investors are taxed in accordance with the limited transparency principle (not the transparent tax regime applicable to ordinary partnerships) and the principles described in section 4.1. apply accordingly.

(3) For purposes of double tax treaties, the German legislature expresses the view that German open-ended investment limited partnerships should be regarded as transparent in accordance with the provisions applicable to ordinary partnerships. This is meant to allow investors to rely on treaty benefit vis-à-vis foreign tax jurisdictions. However, as the investors are taxed in Germany in accordance with different rules (the limited transparency principle; *see* (2) above), foreign tax jurisdictions may take a different view. This should be clarified in advance in cases of doubt.

(4) With regard to non-German group companies investing in a German open-ended investment limited partnership as part of a pension asset pooling strategy, their participation will be deemed not to create a permanent establishment in Germany in order not to attract German tax on their income (their income is subject to German tax in the same way as if they invested in a German investment fund).

(5) The bill now includes a provision that any income generated by a German open-ended investment limited partnership is regarded as being non-commercial. This will allow German tax-exempt investors to invest in such vehicles without triggering tax at their level.

43. Sec. 124 et seq. draft Capital Investment Act.
44. Sec. 125, para. 2, sentence 1, in conjunction with secs. 273 to 284 KAGB-E.
45. Sec. 127, para. 1, sentence 1 KAGB-E.
46. Sec. 15a draft Investment Tax Act as amended by the bill.
47. Sec. 15a, para. 3, sentence 3 draft Investment Tax Act as amended by the bill.

The provisions outlined in section 4.2.2. for investment partnerships[48] apply to any open-ended investment limited partnership which does not qualify as an investment fund, i.e. the "general" principles applicable to any "ordinary" partnership apply to them and their investors.

The bill is silent on the treatment of foreign AIFs which are comparable to a German open-ended investment limited partnership. In the absence of any such provision, the trade tax exemption would not apply in this case. This may not be compatible with the EU's basic freedoms.

5. Outlook

The bill is due to take effect on 22 July 2013. It is well possible that it will still be amended in some material respects. In particular, the taxation of investors in investment corporate vehicles[49] is contentiously debated. The Ministerial Draft published on 4 December 2012 was considered to be too rigorous and in breach of EU law. The approach taken by the bill, which puts commercial investors at a disadvantage but does not affect other investors group like private investors, tax-exempt investors and life and health insurance companies, is rejected by the Second Chamber as being too lenient.

As an alternative, it is presently being discussed to introduce a penalty taxation of German investors in tax-exempt/low-taxed investment corporate vehicles which could be prevented if the fund distributes at least 90% of its profits (similar to REITs). However, it is difficult to determine a consistent computation base for such a 90% test, as foreign investment corporate vehicles will apply their local rules and standards to compute their profits and it would be difficult to monitor any reconciliation to German standards. Therefore, no practical solution has emerged yet.

Other points of debate include: The Second Chamber has taken the view that there is no need for special tax rules meant to promote the new German open-ended investment limited partnership. Further, it wishes to limit the grandfathering provision for existing investment funds until the end of the first fiscal year ending after 22 July 2014.

For the funds industry, which is currently heavily occupied with the implementation of the AIFM Directive, it is very important that the tax framework for funds be finalized soon and that such framework not discriminate against investor groups or products.

48. *See* section 4.2.2.
49. Sec. 19 draft Investment Tax Act in the form of the bill.

Securities Lending and Repo Transactions: Canadian Income Tax Considerations

Securities lending and repo transactions are an important part of the efficient operation of capital markets in Canada. Under Canadian tax law, the same technical rules generally govern the tax treatment and characterization of securities lending and repo transactions. This article provides a summary of the important Canadian federal tax considerations relevant to securities lending and repos, and analyses the impact of the Canadian tax rules.

1. Background

Securities lending involves the transfer of securities from one party (the lender) to another (the borrower) pursuant to an agreement where the borrower agrees to return equivalent securities to the lender at a particular time in the future. To minimize the lender's risk of a failure or default by the borrower, the lender will typically receive collateral from the borrower securing the performance of the borrower's obligations under such securities lending agreement.[1] The collateral provided by the borrower usually consists of cash or other securities with a value equal to the value of the securities transferred by the lender to the borrower plus an additional amount, or margin, to cover fluctuations in the market value of the securities.

While the borrower becomes the absolute owner of the securities received from the lender and is thereby entitled to all economic benefits of holding such securities – including ownership of any distributions (e.g. dividends or interest), the borrower is obliged to remit equivalent amounts to the lender (commonly referred to as "manufactured dividends" or "substitute payments") during the term of the agreement.

In addition, securities lending agreements typically provide for a borrow fee payable by the borrower to the lender. The payment of the borrow fee depends on whether the collateral pledged by the borrower consists of securities or cash. Where securities are pledged as collateral, the borrow fee is typically paid in cash based on a percentage of the transferred securities. Where cash collateral is used, the lender will reinvest the cash and will be obligated to pay the borrower a negotiated below-market investment return (commonly known as "rebate").[2] Any excess reinvestment return is retained by the lender (an implicit borrow fee). At the termination of the SLA, when the borrower returns the securities to the lender, the lender will pay the rebate to the borrower. Amounts earned on the reinvestment of the cash collateral in excess of the rebate are retained by the lender as the borrow fee.

Sale and repurchase (repo) transactions are very similar to securities lending transactions in that they are used to transfer securities (usually fixed income securities such bonds) against cash collateral. Instead of lenders and borrowers, repo transactions involve sellers and buyers. Repo transactions involve one party (the seller) agreeing to sell securities to another (the buyer) for cash, and agreeing to repurchase equivalent securities for a specific price for an amount greater than that value of the transferred securities at a particular time in the future. Distributions (usually interest/coupon) payable on the securities during the term of the repo transaction result in an obligation of the buyer to make an equivalent substitute payment to seller. Instead of a borrow fee, the buyer is entitled to a repo rate or spread that is the amount paid by the seller at the termination of the transaction that exceeds the original purchase price which represents an implicit fee for the account of the buyer. If either party provides margin (amounts paid as collateral during the term of the agreement) to the other to cover the risk of the fluctuating value of the transferred securities, the holder of such margin invests the cash and pays interest to the provider.

While securities lending transactions are often driven by the borrower's need to obtain specific securities (to fulfil a short sale, for example), a repo transaction is often motivated by the seller's need to borrow cash (effectively, monetizing the seller's fixed income assets).

2. Canadian Income Tax Considerations

The Income Tax Act(Canada) (the ITA)[3] has specific provisions that deal with securities lending arrangements (SLAs). In most cases, these rules apply equally to repo transactions. As the Canadian tax rules applicable to securities lending and repos are written in the context of securities lending transactions, the terms used in this article (e.g. borrower and lender) will also reflect that perspective, unless specifically noted. Securities lending or repo transactions that do not fall

* Partner, Fasken Martineau DuMoulin LLP, Toronto.

1. Most Canadian securities lending arrangements follow US documentation. In those circumstances, the recipient of collateral does not acquire beneficial ownership of the collateral but rather holds only a security interest therein. Unless otherwise stated, it is assumed for purposes of this article that the beneficial ownership of collateral provided is not transferred to the holder of the collateral.
2. In recent years, low interest rates have resulted in borrowers paying negative rebates to lenders in order to adequately compensate lenders, as the returns on reinvested cash collateral are very low.
3. Unless otherwise specified, all statutory references herein are to the ITA. Many of the provision referred to herein are subject to proposed amendments as part of draft legislation contained in Bill C-48. At the time of writing, Bill C-48 has had a second reading in the Canadian House of Commons and is at the report stage. In this article, it is assumed that this proposed legislation will be enacted in the form currently proposed. Typically, amendments to Canadian tax law are made retroactively effective to the date the amendments were first announced. In most cases, the proposed amendments discussed herein will be made effective for securities lending arrangements that occur after 2001. However, readers are cautioned that there are circumstances where proposed legislation is subject to certain taxpayer elections or staggered effective dates.

within the definition of an SLA are not subject to these specific provision and will be discussed briefly further below.

2.1. Securities lending arrangements

An SLA[4] is an arrangement under which:

- a person (the lender) transfers or lends a qualified security to another person (the borrower);
- it may be reasonably expected that the borrower will transfer or return to the lender a security that is identical to the security so lent or transferred;
- the borrower is obliged to pay to the lender amounts equal to and as compensation for all amounts, if any paid on the security that would have been received if the borrower had held the security throughout the term of the arrangement ending at the time when an identical security is transferred or returned to the lender;
- the lender's risk of loss or opportunity for gain or profit with respect to the security is not changed in any material respect; and
- if the lender and the borrower do not deal with each other at arm's length, it is intended that neither the arrangement nor any series of SLAs, loan or other transactions of which the arrangement is a part be in effect for more than 270 days.

However, an SLA does not include an arrangement one of the main purposes of which may reasonably be considered to be to avoid or defer the inclusion in computing income for tax purposes any gain or profit with respect to the security. This exclusion is an anti-avoidance provision intended to prevent the deferral of gains or profits through the use of SLAs. Where this exclusion applies, the tax consequences to a lender would not be subject to the application of the rules applicable to SLAs.

2.2. Qualified security

A qualified security[5] includes the following:

(1) a share of a class of capital stock of a corporation listed on a stock exchange;[6]

(2) a bond, debenture, note or similar obligations of a corporation described in (1) or a corporation that is controlled by such a corporation;

(3) a bond, debenture, note or similar obligation of or guaranteed by the government of any country, province, state, municipality or other political subdivision, or a corporation, commission, agency or association controlled by any such government entity;

(4) a warrant, right or option or similar instrument with respect to a share described in (1); or

(5) a qualified trust unit.

"Qualified trust unit" means an interest, as a beneficiary under a trust, that is listed on a stock exchange. As a result, units of an exchange traded fund (ETF) that is organized as a trust should be a qualified security.

2.3. Characterization issues

2.3.1. Non-disposition – domestic transactions

Where a securities lending (or repo) transaction qualifies as an SLA, the transfer of the qualified security by the lender to the borrower is deemed not to be a disposition by the lender for Canadian income tax purposes.[7] As a result, taxable lenders will not recognize any accrued gains or losses on the loaned security.

A borrower under an SLA will be considered to have acquired the transferred security for Canadian tax purposes.

2.3.2. Substitute payments – domestic transactions

For Canadian tax purposes, substitute payments are divided into two categories: SLA compensation payments and dealer compensation payments.[8] The characterization of these payments for Canadian tax purposes are subject to an anti-avoidance exception described below.

An SLA compensation payment means an amount paid pursuant to an SLA as compensation for an underlying payment. For these purposes, an underlying payment means an amount paid on a qualified security by the issuer of the security.

A dealer compensation payment means an amount paid or received by a registered securities dealer resident in Canada as compensation for an underlying payment, where the amount is paid or received in the ordinary course of a business of trading in securities.[9] There is no requirement that a dealer compensation payment be part of a qualifying SLA.

A substitute payment in respect of a taxable dividend on shares of a Canadian corporation will be characterized as a taxable dividend paid by a Canadian corporation for Canadian resident lenders if it the substitute payment is received as an SLA compensation payment from a borrower that is a Canadian resident or a non-resident of Canada where such non-resident borrower paid the amount in the course of carrying on business in Canada through a permanent establishment. If the substitute payment is a dealer compensation payment, the character of the taxable dividend is preserved even if the transaction is not a qualifying SLA. In this manner, certain favourable tax treatment extended to Canadian taxable dividends is maintained for Canadian resident lenders.[10]

4. The definition of "securities lending arrangement" described above is provided for under Bill C-48.
5. The definition of "qualified security" described above is provided for under Bill C-48.
6. A share of a designated class of the capital stock of a Canadian public corporation is also a qualified security where the corporation has made an election or the Minister of National Revenue (Canada) has provided a notice as provided for in the definition of "public corporation" in subsection 89(1).
7. Subsec. 260(2). Specific anti-avoidance rules may apply to deny this characterization. These rules may apply where the borrower returns property to the lender that is different from the original transferred security or where it may reasonably be considered that the lender would have received proceeds of disposition for the security if it had not been transferred to the borrower. *See* subsections 260(3) and (4).
8. The definitions of "SLA compensation payment", "dealer compensation payment" and "underlying payment" and the deeming rules described above are provided for under Bill C-48.
9. Subsection 248(1) defines "registered securities dealer" as a person registered or licensed under the laws of a Canadian province to trade in securities, in the capacity of an agent or principal, without any restriction as to the types or kinds of securities in which that person may trade.
10. For dividends paid after 2005, subsection 260(1.1) provides that an amount received by a Canadian resident person that is deemed to be a

If the substitute payments relate to an underlying payment by a trust on a qualified trust unit, the substitute payments will maintain the characteristics and source of the underlying payment.

In all other cases, SLA compensation payments and dealer compensations payments received by a Canadian resident lender are deemed to be interest. For example, where the underlying payment is a dividend paid by a non-Canadian corporation, an SLA compensation payment or dealer compensation payments received by a Canadian resident lender is deemed to be interest for Canadian tax purposes.

The foregoing characterization rules applicable to substitute payments are subject to the anti-avoidance exception referred to above. This exception applies where an amount is received as proceeds of disposition or an amount is received by a person under an arrangement where it may reasonably be considered that one of the main reasons for the person entering into the arrangement was to enable the person to receive an SLA compensation payment or dealer compensation payment that would be deductible in computing the income for any taxation year of the person.[11]

A borrower is generally not entitled to a deduction in computing its income for substitute payments that are characterized as Canadian taxable dividends.[12] However, if the borrower is a registered securities dealer, it may deduct an amount equal to two thirds of the dealer compensation payments that it pays which are characterized as Canadian taxable dividends. All other SLA compensation payments or dealer compensation payments may be fully deductible by the borrower in computing its income for Canadian tax purposes to the extent the borrower has disposed of the transferred securities and included the gain (or loss) in computing its business income for the year. In all other circumstances, the deductibility of SLA compensation payments or dealer compensation payments by the payer is limited to the lesser of (i) the amount of such payment or (ii) the amount of the distribution on the qualified security to which such payment relates that was included in computing the taxable income of the payer or a person related to it.[13]

2.3.3. Substitute payments – cross-border transactions

For Canadian non-resident withholding tax purposes, substitute payments paid by a Canadian resident borrower to a non-resident lender in respect of dividends and interest on the underlying transferred securities are generally deemed to be payments of interest[14] and therefore, subject to certain exceptions discussed below, are not subject to Canadian withholding tax under the ITA to the extent that the borrower and lender are dealing at arm's length.[15]

Generally speaking, substitute payments that are deemed to be interest are not deemed to be paid on the underlying security. However, a substitute payment will maintain its character as a dividend or interest on the underlying security for Canadian withholding tax purposes if the SLA is collateralized throughout its term with money or government debt having a value equal to at least 95% of the loaned securities and the borrower is entitled to enjoy, directly or indirectly, the benefit of all or substantially all (generally, 90% or more) of the income derived from the collateral and any opportunity for gain on the collateral.[16] Such deemed dividend or interest is deemed to be paid by the borrower. As a result, where corporation shares are transferred under an SLA, the use of government debt or cash collateral can have the effect of triggering Canadian withholding tax of 25% on any substitute payments paid by a Canadian resident borrower (whether or not the corporate issuer is a Canadian resident), subject to a reduction under an applicable tax treaty.

An exception to the general exemption from Canadian withholding tax on arm's length interest applies in respect of participating debt interest. Participating debt interest is broadly defined and includes interest that is paid on an obligation all or any portion of which is contingent or dependent on the use of or production from property in Canada, or is computed by reference to revenue, profit, cash flow, commodity price or similar criterion or by reference to dividends paid or payable by a corporation.[17] Therefore, to the extent that substitute payments are deemed to be interest and such interest can be said to be participating debt interest, then 25% Canadian withholding tax will apply on such substitute payments (unless reduced under an applicable income tax treaty). For example in circumstances where corporate shares are loaned and the loan is not fully collateralized as described above, any substitute payment would be deemed to be interest. Arguably, as such deemed interest may be computed by reference to dividends paid on the loaned shares, the substitute payment may be considered participating debt interest subject to withholding tax. Similar concerns could arise where fixed income securities are loaned and the interest payable on such securities is caught within the meaning of participating debt interest. The Canada Revenue Agency (CRA) has applied a narrow interpretation of the meaning of participating debt interest in other contexts but, to date, no public comments have been made about the application of the interpretation of participating debt interest in the context of an SLA.

Where a non-resident lender does not deal at arm's length with the Canadian resident borrower or the issuer of the security that is transferred, substitute payments deemed to be interest may be subject to Canadian withholding tax, subject to exemption or reduced rates under an applicable tax treaty.[18]

Certain withholding tax exemptions on interest may apply where the interest is fully exempt interest.[19] Fully exempt

taxable dividend under subsection 260(5.1) may be an eligible dividend within the meaning of subsection 89(1).

11. Proposed amendments to subsection 260(5) are provided under Bill C-48.
12. Proposed para. 18(1)(w) provided for under Bill C-48. When enacted, the proposed legislation is generally retroactively effective to 1 January 2002. Proposed subsection 206(6.1) provides for special rules that apply to a corporate borrower where the SLA is a dividend rental arrangement. Dividend rental arrangements are subject to specific provisions intended to eliminate the tax benefits of receiving Canadian taxable dividends. Consideration of these anti-avoidance provisions is beyond the scope of this article.
13. Proposed amendments to subsec. 260(6) provided for under Bill C-48.
14. Proposed amendments to para. 260(8)(a) provided for under Bill C-48.
15. Para. 212(1)(b).
16. Proposed para. 260(8)(c) provided for under Bill C-48.
17. Subsec. 212(3).
18. Subsec. 260(10) and para. 212(1)(b).
19. Subsec. 212(3) and proposed subpara. 260(8)(c)(ii) provided for under Bill C-48.

interest includes interest paid or payable on certain government indebtedness and certain substitute payments in respect of a collateralized SLA that are deemed to be interest if the SLA was entered into by the borrower in the course of carrying on a business outside of Canada and the loaned security is a bond, debenture, note or similar obligations issued by a non-resident public corporation or by any government or political subdivision or agency of such government.

Substitute payments in respect of qualified trust units maintain their underlying character for non-resident withholding tax purposes.[20] To the extent that withholding tax is payable on the distribution by the issuer of the qualified trust units, a 25% withholding tax is also payable on the substitute payment by a borrower to a non-resident lender, subject to reduction under an applicable tax treaty.

Where an SLA is collateralized with other securities (or in the case of a repo transaction where the margin provided is non-cash), it is possible for Canadian non-resident withholding tax to be payable on the substitute payments in respect of distributions received on such collateral that is held by a Canadian resident lender to which the non-resident borrower is entitled. This issue depends on (i) whether the lender has merely a security interest in the collateral or if the transfer of collateral represents a separate SLA where beneficial ownership of the collateral securities are transferred to the lender and (ii) whether the collateral securities are held over a distribution record date.

There are no Canadian withholding taxes applicable to substitute payments paid in respect of a securities loan or repo between a non-resident lender and a non-resident borrower, even if the underlying security is issued by a Canadian entity. Obviously, a non-resident owner of the security may be subject to Canadian non-resident withholding tax on actual distributions received.

2.3.4. *Borrow fees/repo spread – domestic transactions*

Borrow fees received will generally be included in computing the income of a taxable Canadian lender. A Canadian borrower may generally deduct the borrow fees it pays in computing its income for tax purposes.

As the ITA does not have specific rules applicable to repo transactions and the rules applicable to qualified SLAs do not contemplate the tax consequences of a repo spread, the Canadian tax treatment is subject to general principles. Generally speaking, any repo spread earned by a buyer would likely be characterized as interest and be included in computing the buyer's income for Canadian tax purposes.[21]

2.3.5. *Borrow fees/repo spread – cross-border transactions*

Borrow fees are deemed to be interest when paid by a Canadian borrower to a non-resident lender.[22] However, borrow fees are not deemed to be interest on the borrowed security, even if it is a collateralized government debt loan.

If no borrow fee is payable because the Canadian borrower has provided the lender with cash collateral, an imbedded fee is deemed to have been paid for an amount equal to a prescribed interest rate times the cash collateral provided less any rebate paid to the lender.[23] These amounts are not subject to Canadian withholding tax, provided that the borrower and lender deal at arm's length.

Under a repo transaction, the same provisions that apply to imbedded fees to a lender under an SLA may apply to a seller under a repo transaction. If a Canadian resident buyer has provided the non-resident seller with cash on the transfer of securities and the buyer does not pay any fee to the seller, the buyer may be deemed to have paid a borrow fee to the seller at the time the transferred securities are returned to the seller. The amount of the deemed borrow fee is equal to the amount by which the interest on the original cash payment computed at a prescribed interest rate during the term of the repo exceeds the repo spread (subject to adjustment where cash margin has been provided). To the extent that the buyer and seller deal at arm's length, no Canadian withholding tax should be payable in respect of the repo spread.

2.3.6. *Rebates – domestic transactions*

The borrower will include in computing its income the amount of any rebate it receives from the lender where it has provided cash collateral. Any negative rebate paid by the borrower should generally be deductible. In computing its income, a taxable Canadian lender will include the income from the investment returns in respect of the cash collateral (net of any rebate paid or including any negative rebate received).

2.3.7. *Rebates – cross-border transactions*

A rebate paid by a Canadian resident lender to an arm's length non-resident borrower on cash collateral is regarded as interest by the CRA and will generally not be subject to withholding tax as such.

Any negative rebate paid under an SLA is deemed to be interest when paid by a Canadian borrower to a non-resident lender and is not subject to Canadian withholding tax, provided that the borrower and lender deal at arm's length.[24]

2.4. Impact of tax treaties

Tax treaties can reduce the impact of Canadian non-resident withholding tax that may be payable in connection with SLAs or repo transactions.

For example, article XI of the Canada-United States Income and Capital Tax Treaty (1980) (Canada-United States treaty) provides interest payments made by a person resident in Canada to a person resident in the United States are not subject to Canadian withholding tax. This means that a US resident that is paid participating debt interest by a Canadian resident may be exempt from Canadian withholding tax by virtue of the Canada-United States treaty. However, similar to the participating debt interest exception under the

20. Proposed para. 260(8)(b) provided for under Bill C-48.
21. *See* e.g. CRA *Technical Interpretation*, Cross-border repurchase transactions, document No. 9728405, dated 25 Mar. 1998.
22. Proposed para. 260(8)(d) provided for under Bill C-48.
23. Proposed para. 260(8.1) provided for under Bill C-48.
24. Proposed para. 260(8)(d) provided for under Bill C-48.

ITA, the elimination of Canadian withholding tax on interest under the Canada-United States treaty does not extend to participating interest. "Participating interest" is defined as interest that is determined with reference to: (i) receipts, sales, income, profits or other cash flow of the debtor or a related person, (ii) any change in the value of any property of the debtor or a related person or (iii) any dividend, partnership distribution or similar payment made by the debtor to a related person. While the definition of "participating interest" under the Canada-United States treaty is similar to the definition of "participating debt interest" under the ITA, they are not identical and can therefore have different applications. As the definition of "participating debt interest" is broader than that of "participating interest", it may be possible to pay participating debt interest that is exempt from Canadian withholding tax, provided that the participating feature is not determined with reference to the above criteria that relate to the economic performance of the borrower or a related person. In other words, if the underlying payment on fixed income securities qualifies as "participating debt interest" under the ITA but does not meet the qualifications of "participating interest" under the Canada-United States treaty, substitute payments paid by a Canadian resident borrower to a US resident lender may be exempt from Canadian withholding tax due the elimination of Canadian withholding tax on interest under that treaty.

Interest that falls within the above definition of "participating interest" under the Canada-United States treaty will be treated as a dividend and will be subject to Canadian withholding tax at the 15% treaty rate generally applicable to dividend payments.

Non-resident tax-exempt lenders that are exempt from Canadian tax under an applicable tax treaty may rely on provisions like article XXI of the Canada-United States treaty (US pension funds, IRAs and US tax-exempt charities) to avoid being subject to Canadian withholding tax on substitute payments in respect of dividends and interest and on borrow fees received from a Canadian resident borrower. While pension funds and IRA lenders covered under article XXI of the Canada-United States treaty are not exempt from Canadian withholding tax on substitute payments in respect of distributions on qualified trust units, US charities and other tax exempts described in paragraph 1 of article XXI are exempt on such substitute payments.

2.5. Canadian tax compliance

Where payments are made under an SLA or repo transaction, Canadian tax compliance and filings will, in many circumstances, be required.

For example, if substitute payments are paid by a Canadian resident borrower to a non-resident lender, the amount of such payments (whether or not they are subject to Canadian non-resident withholding tax) must be reported on an annual basis using an information slip (NR4) that is provided to the lender and to the CRA.

Where a payment under an SLA or repo transaction is subject to Canadian non-resident withholding tax, the tax is imposed on and payable by the non-resident recipient. However, in addition to the tax reporting requirements, the Canadian-resident payer is obliged to withhold the tax and remit it to the CRA. Similarly, if an agent of the payer makes the payment to the non-resident, the agent is obliged to withhold and remit the tax. The payer and the agent will be liable for the amount of the tax, plus interest and potential penalties, if it fails to withhold and remit as required. Withholding tax is to be remitted to the CRA on or before the 15th day of the month following the month in which the amount was paid or credited to the non-resident.

Payments between Canadian resident borrowers and Canadian resident lenders are also subject to Canadian tax information reporting (T5 information returns).

3. Non-Qualified Transactions

If a securities loan or repo transaction is not an SLA as defined in the ITA, there are generally no other specific applicable statutory rules, and the general rules under Canadian domestic tax and withholding tax law will apply. For example, general principles will apply where a lender transfers to a borrower corporation shares that are not listed on a stock exchange.

Where a non-qualified transaction occurs, the transfer of the securities to the borrower would be treated as a disposition of the securities by the lender. Canadian resident taxable lenders will trigger otherwise unrealized gains or losses, notwithstanding that the lender remains economically invested in the underlying securities throughout the term of loan. The borrower would acquire the securities with cost equal to the fair market value of such securities at the date of the transfer.

The CRA's historical position has been that any repo spread earned by the buyer in a repo transaction that is not part of a qualified SLA is interest. On this basis, any repo spread may be required to be included as interest in computing the buyer's income for Canadian tax purposes.[25]

Substitute payments would not receive favourable tax characterization afforded to Canadian taxable dividends where the underlying securities are Canadian corporation shares. Generally, the payment of fees and substitute payments should be deductible by the payer and included in computing the income of the recipient. Rebate payments would be treated as interest for tax purposes.

The Canadian withholding tax consequences for most of the typical payments under a non-qualified securities lending arrangement or repo transaction are often unclear. Substitute payments and borrow fees paid to a non-resident by a Canadian resident may arguably not be subject to withholding tax, as such payments do not fall under the enumerated categories of income from property that typically attract withholding taxes for non-residents (e.g. dividends, interest, royalties). However, in some cases (e.g. repo spread or rebates on cash collateral), the payment may be properly characterized as interest and therefore, to the extent the payment is made between arm's length parties, no Canadian withholding tax will be payable.

25. *Supra* n. 21.

Anuschka J. Bakker*

Impact Investing: What Are We Talking About? – Part I

The author provides an overview of impact investing. Before delving into the tax issues related to impact investing (*see* Part II of this article), the author provides in Part I insight into what constitutes impact investing, why it has grown in recent years, why impact investing matters and which parties are involved.

1. Introduction

Rarely has a field been so energized by a new idea as impact investing. Impact investments are investments made into companies, organizations and funds with the intention to generate measurable social and environmental impact alongside a financial return.[1] Impact investing is, at its essence, a way to unlock capital and place it in businesses and projects that generate real social and environmental benefits for the people who need those benefits. The idea is for example to generate more and better jobs, give people access to affordable housing, clean water and education and at the same time generate a financial return to the investor.

The concept of intentionally deploying capital to produce both financial and non-financial returns is not new. In fact, some would argue that the earliest human economic exchanges sought, in the interest of the common good, to do both, and that doing both was seen as natural. As Biehl, Hoepner and Liu state, the idea of fairness and responsibility during a transaction is most likely as old as manhood. Several religions, such as Judaism through the Torah, indirectly provide evidence of fair trade guidelines as far back as at least 1312 BC. Aristotle wrote a philosophical guideline for responsible trade around 300 BC.[2] It goes back to the Quakers in seventeenth-century England who sought to align their investment and purchase decisions with their values. The concept can also be linked with the Shaker congregations in the 1800s that launched businesses in alignment with their social values and to fund religious communities. Impact investing is also linked to the anti-apartheid movements in the 1980s, and Muhammad Yunus and the Grameen bank are yet further examples of impact investing. The concepts of microfinance and microcredit have spread to all regions of the world and have enormous social impact.[3] For an overview of the evolution of social, environmental and trust ideas over the decades, reference can be made to Biehl, Hoepner and Liu.[4]

When such a relatively young kid like impact investing is on the block, one would like to know what it is, how it works, the market size, etc. Part I of this article will consider terms and definitions, why impact investing matters, the spectrum of impact investors, market size, opportunities and challenges.

2. Terms and Definitions

2.1. Introduction

Many different terms and definitions are used in the field of socially responsible investing. The following overview presents some terms that are used in the context of socially responsible investing.[5]

Investment approach	
Sustainable investing	Integrates long-term environmental, social and governance (ESG) criteria into investment and ownership decision making, with the objective of generating superior risk-adjusted financial returns. These extra-financial criteria are used alongside traditional financial criteria such as cash flow and price-to-earnings ratios.
Responsible investing	Integrates consideration of ESG issues into investment decision-making and ownership practices, thereby improving long-term returns to beneficiaries. NB: This definition is derived from the UN-backed Principles for Responsible Investment. In this article, the terms "sustainable investing" and "responsible investing" are used interchangeably.
Ethical investing	Philosophy guided by moral values, ethical codes or religious beliefs. Investment decisions include non-economic criteria. This practice has traditionally been associated with negative screening.
Impact investing	Investment approach that aims to proactively create positive social and environmental impact against an acceptable risk-adjusted financial return. This requires the management of social and environmental performance (in addition to financial risk and return). With impact investing, "impact" comes first, whereas with sustainable investing, "financial returns" come first.

* Manager Topical Publications, IBFD, Amsterdam.

1. *See* http://www.thegiin.org/cgi-bin/iowa/resources/about/index.html#1, accessed 21 Mar. 2013.
2. C. Biehl, A.G.F. Hoepner & J. Liu, Social, Environmental, and Trust Issues in Business and Finance, in *Socially Responsible Finance and Investing: Financial Institutions, Corporations, Investors and Activists*, H.K. Baker & J.R. Nofsinger (eds.) (John Wiley & Sons, Inc. 2012), at 112.
3. A. Bugg-Levine & J. Emerson, *Impact Investing: Transforming How We Make Money While Making a Difference* (John Wiley & Sons, Inc. 2011) at 5-6.
4. Biehl, Hoepner & Liu, *supra* n. 2, at 111-141.
5. Source: M. Kerste, N. Rosenboom, B.J. Sikken. & J. Weda, *Financing sustainability* (VU University Press 2011), at 157-158.

Investment approach	
SRI*	Generic term covering ethical investments, responsible investments, sustainable investments and any other investment process that combines investors' financial objectives with their concerns about ESG issues.

* Traditionally, the term "SRI" means "socially responsible investment". The European Sustainable Investment Forum (Eurosif), a pan-European network and think tank the mission of which is to develop sustainability through European financial markets, also uses the term "SRI", but has changed its direct meaning to "sustainable and responsible investment", which encompasses all of the subsets discussed above.

In literature,[6] one also distinguishes social finance. For example the Canadian Forum socialfinance.ca defines "social finance" as:

> [...] an approach to managing money that delivers social and/or environmental benefits, and in most cases, a financial return. Social finance encourages positive and environmental solutions at a scale that neither purely philanthropic supports nor traditional investment can reach.

Social finance and banking seek to achieve a positive social impact through finance and banking. A positive social impact includes an impact on society, the environment or sustainable development. Weber and Duan distinguish social finance, social banking and socially responsible investment. In contrast to social finance, socially responsible investment (SRI) integrates social or environmental criteria into the set of investment indicators. Weber and Duan[7] divide social finance into three categories, namely social banking, impact investing and microfinance. In this article, impact investing will be addressed.

2.2. Impact investing defined

Establishing an agreed definition of "impact investing" seems not an easy task. This one can deduce from the many definitions that are being used. In 2007 and in 2008, the Rockefeller Foundation convened meetings at its Bellagio Center to explore with leaders in finance, philanthropy and development the need for and ways and means of, building a worldwide industry for investing for social and environment impact. The 2007 meeting coined the term and concept of "impact investing" itself. There are many definitions of the term "impact investing". The Monitor Institute[8] defines "impact investing" as "[a]ctively placing capital in businesses and funds that generate social and/or environmental good and at least return nominal principal to the investor". The Global Impact Investing Network (GIIN) defines "impact investing" as follows:

> Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.[9]

Jones[10] defines "impact investing" more generally as "the use of for-profit investment to address social and environmental problems".

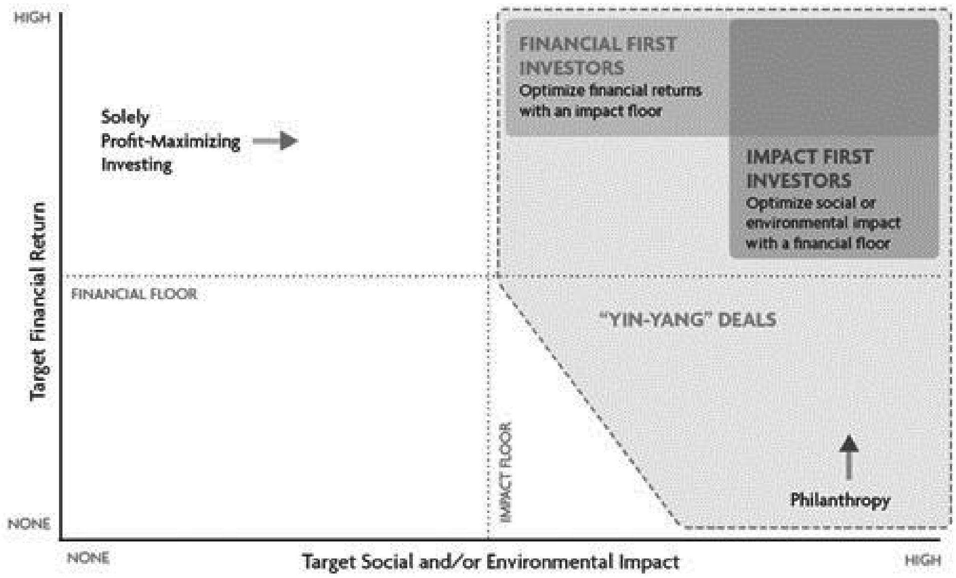
Some argue that impact investing primarily focuses on direct investments in social businesses/enterprises in developing and emerging markets by western investors. O'Donohoe, Leijonhufvud and Saltuk argue that impact investment is an emerging asset class.[11] Harji and Jackson, however, argue that impact investment can occur across a range of regions, across asset classes and across sectors.[12] This can also be deduced from the ImpactAssets 50 list, which is a list of fund managers that seek intentional social and environmental returns. It covers a wide range of sectors and asset classes.[13]

According to Harji and Jackson, whether an investment can be considered impact investment should be tested on two grounds, namely (i) there must be an intent to create meaningful social and environmental impact and (ii) there must be evidence of tangible social and environmental impacts or effects, for the ultimate target populations or areas. In addition, Harji and Jackson suggest that an impact investment should also provide evidence of a specific theory of change that sets out how the investor envisions its capital flowing and how it will actually generate downstream results on key performance indicators.[14]

The above-mentioned definitions of "impact investing" have the following in common: the achievement of a positive societal, environmental, or sustainability impact by capital investment. In addition to the financial return, the impact investors are focused on a positive societal, environmental or sustainability impact. Targeted areas of impact investors are in both emerging and developed markets and include affordable housing, health care, nature conservation, education, renewable energy and financial services for the poor. Freireich and Fulton[15] segment impact investors into two categories, namely impact-first investors and financial-first investors. The primary goal of impact-first investors is to achieve a social or environmental impact, with a secondary goal of financial return. They are more likely to be able to accept concessionary returns ranging from repayment of principal to market rate. The primary goal of financial-first investors is to achieve a financial return, with a secondary goal of social or environmental impact. Sometimes impact-first and financial-first

6. O. Weber & Y. Duan , Social Finance and Banking, in *Socially Responsible Finance and Investing: Financial Institutions, Corporations, Investors and Activists*, H.K. Baker and J.R. Nofsinger (eds.) (John Wiley & Sons, Inc. 2012), at 161-162.
7. Weber & Duan, *supra* n. 5, at 162.
8. J. Freireich & K. Fulton, *Investing for Social and Environmental Impact: A Design for Catalyzing an Emerging Industry* (Monitor Institute 2009), at 11.
9. *See* http://www.thegiin.org/cgi-bin/iowa/investing/index.html, accessed 1 Feb. 2013.
10. J.F. Jones, *Social Finance: Commerce and Community in Developing Countries*, 37 Intl. J. Social Econ. 6 (2010), at 415.
11. N. O'Donohoe, C. Leijonhufvud & Y. Saltuk, *Impact Investments: An Emerging Asset Class* (J.P. Morgan Research 29 Nov. 2010), at 25-29, available at http://www.rockefellerfoundation.org/uploads/files/2b053b2b-8feb-46ea-adbd-f89068d59785-impact.pdf.
12. K. Harji & E.T. Jackson, *Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry*, E.T. Jackson and Associates Ltd, prepared for The Rockefeller Foundation, New York, July 2012, at 7.
13. *See* http://www.impactassets.org/impactassets-50, accessed 21 Mar. 2013.
14. Harji & Jackson, *supra* n. 11, at 8.
15. Freireich & Fulton, *supra* n. 7, at 31.

Diagram 1



investors work together in what are sometimes referred to as yin-yang deals, i.e. deals that combine capital from impact-first and financial-first investors and sometimes add in philanthropy, as well. This name is derived from the term in Chinese philosophy describing two elements that are different and yet complementary when put together. Yin-yang deal structures can enable deals that could not happen without the blending of types of capital with different requirements and motivations. This is represented in Diagram 1.[16]

The above seems to imply that impact investing is some trade-off. Bugg-Levine and Emerson[17] (2011) and Emerson[18] speak of "blended value proposition" (BVP), a term created by Emerson. The BVP integrates and affirms the greatest maximization of social, environmental and economic value within a single firm (whether for-profit or non-profit), investment opportunity or community. This value proposition must be framed in terms that make sense to all investor stakeholders along the spectrum. Bugg-Levine and Emerson[19] state:

> [...] many people approaching this task [meaning impact investment – clarified by author] are still locked in old language and mind-sets. They are used to orienting themselves around financial return and therefore define impact investments as below-market-rate investment that trade-off financial return for social impact. Although these investments certainly form part of the impact-investing universe, the heart of the movement is the reorientation around blended value as the organizing principle of our work: using capital to maximize total, combined value with multiple aspects of performance.

16. Freireich & Fulton, *supra* n. 7, at 3l-33. The following should be borne in mind: (i) some investors may have wide-ranging portfolios that touch on different approaches in different investments, (ii) the size and importance of the segments will differ depending on the sectors and geography involved and (iii) many investors in both segments aspire to maximize both objectives depicted in the area where these two segments overlap in the uppermost right-hand corner of the graph.
17. Bugg-Levine & Emerson, *supra* n. 3, at 9-11.
18. J. Emerson, *The Blended Value Proposition: Integrating Social and Financial Returns*, 45 Cal. Mgt. Rev. 4 (2003), at 35-51.
19. Bugg-Levine & Emerson, *supra* n. 3, at 9.

Based on the above, one can conclude that impact investing is still in the early stages of development or is not a matured industry. Indeed, the lack of a unified definition is characteristic of a field which is still in an early stage of development.

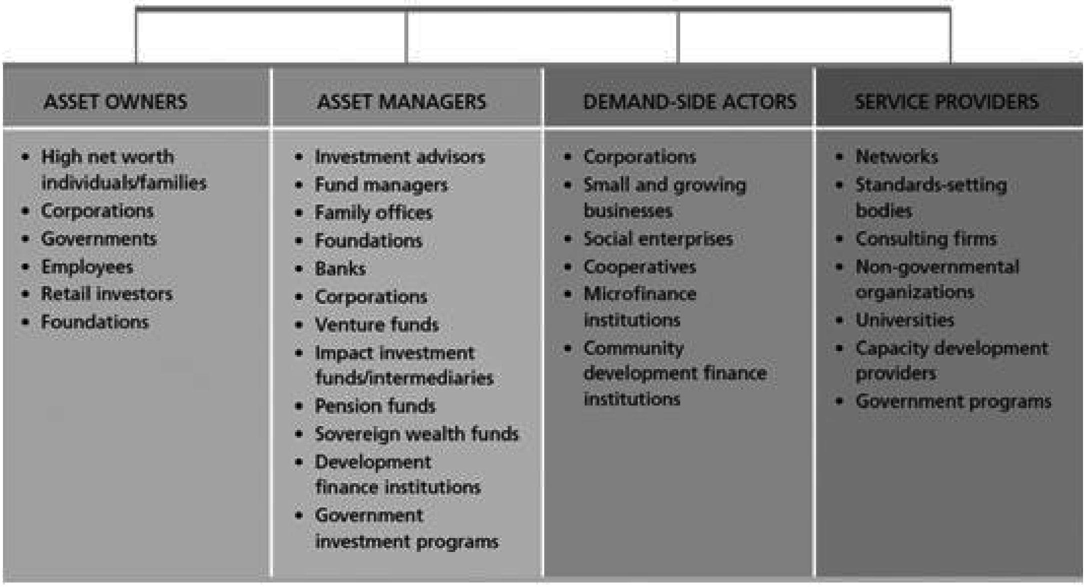
3. Why Impact Investing Matters

Today's world knows many social and environmental challenges. What is new, according to Bugg-Levine and Emerson,[20] is that impact investors are optimistic about the role that business can play in advancing the common good. They do realize that market-based strategies have their limits for social change. A functioning impact investing industry has the potential to complement government and philanthropy by unlocking significant resources to address these social and environmental challenges. In addition, the increasing awareness of the escalating disparity in the way wealth is distributed,[21] unequal access to opportunities and a mounting concern for the environment have led to increased pressure to solve these seemingly intractable problems. More than one billion people in the developing world live at poverty levels that are unacceptable.[22] Even a look at the website of the United Nations shows what work is necessary in the field of the UN Development Goals.[23] The sources available to address these challenges are finite and, in some cases, growing scarcer.

Initiatives for environmental and social change are traditionally more undertaken by government. There have been some developments in this respect. The role of the governments changed. First, governments have been decreasing their revenue in respects to free market ideol-

20. Bugg-Levine & Emerson, *supra* n. 3, at 6.
21. World Bank, *2007 World Development Indicators* (World Bank 2007).
22. Data indicate that nearly 1.3 billion people live on less than USD 1.25 per day. *See* World Bank, *Poverty Picture – 1990-2008*, available at http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTPOVERTY/0,,print:Y~isCURL:Y~menuPK:336998~pagePK:149018~piPK:149093~theSitePK:336992,00.html, accessed 21 Mar. 2013.
23. *See* http://www.un.org/millenniumgoals/, accessed 21 Mar. 2013.

Diagram 2



ogies ever since the 1980s.[24] A more neoliberal approach led to shrinking funds, resulting in fewer and different interventions by the public sector. Second, it is also recognized that the progress in alleviating the ills of our times requires more than government intervention alone.[25] As can be seen in section 5. of this article, the impact investing sector has grown tremendously since 2007. A critical note or some scepticism may seem warranted. As mentioned, ultimately the goal of impact investing is to make a significant dent on many of the world's daunting social and environmental problems. One can ask oneself whether private, profit-motivated investment can deliver permanent social change. An optimist will cite the success of microfinance, while pessimists will cite the dark sides of microfinance such as over-lending and very high interest rates.

On the other hand it seems unfair to charge one sector – the impact investing sector – with carrying all the burden of addressing humanity's social and environmental problems. Freireich and Fulton sketched a scenario of how impact investing could succeed. They see that impact-driven investors effectively develop skills and approaches which enable them to leverage investment as a tool to drive social change. Impact investing would outstrip philanthropy in terms of capital volume and, some would argue, impact. A range of supporting infrastructure would enable investors to better understand choices and trade-offs.[26] They do indentify some risks/reasons why impact investing could fail, namely:

– the risk that the industry will become collateral damage in the global economic slowdown that took hold during 2008;
– the risk that investing for impact will ultimately be too difficult. Current challenges could become persistent obstacles and insufficient compensation for risk may result in lack of interest in impact investing; and
– the risk that investing for impact will ultimately be too easy.

Here, the definition of "social and environmental impact" would turn out to be so loose and diluted as to be virtually meaningless. Impact investing would become something involving feeling good instead of doing good. There is another side to this last point. Impact investing would lure capital away from philanthropy, decreasing the amount of resources dedicated to confronting serious societal challenges. In all honesty, the fact is that there is also much green washing due to the existing financial markets and incentives. And some parties may be included to decrease the standards of what is considered "impact". However, this can be addressed by developing clear metrics that create greater transparency as regards impact.[27]

4. Spectrum of Impact Investors

Which parties can be considered to be impact investors? Impact investing has attracted the interest of a growing number of foundations, development finance institutions, private foundations, large scale financial institutions, private wealth managers, commercial banks, retirement fund managers, boutique investment funds, companies and community development finance institutions.[28]

For an overview of the members of for example GIIN, *see* http://www.thegiin.org/cgi-bin/iowa/council/member/index.html (accessed 3 February 2013). The members of the Investors' Council of GIIN[29] come from different fields:

24. A. Nicholls (ed.), *Social Entrepreneurship: New Models of Sustainable Social Change* (Oxford University Press 2006), at 99-118.
25. *Let's Hear Those Ideas*, The Economist (12 Aug. 2010).
26. *See* Freireich & Fulton, *supra* n. 7, at 37-42.
27. Freireich & Fulton, *supra* n. 7, at 34-35.
28. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 7.
29. The GIIN Investors' Council is a leadership group of active large-scale impact investors. Comprised of asset owners and asset managers with diverse interests across sectors and geographies, the Investors' Council provides a forum for experienced impact investors to strengthen the practice of impact investing and accelerate learning about new areas in the field.

charitable organizations (e.g. Belinda and Bill Gates Foundation), financial organizations (e.g. J.P. Morgan), microfinance (e.g. ACCION) and commercial impact investors (e.g. Sarona). Dutch members include SNS Impact Investing, Triodos Investment Management and FMO (the Dutch Development Bank). Dutch members of the GIIN Network[30] include Robeco and Triple Jump. An overview of the various players in the field is provided in Diagram 2.[31]

As stated, impact investing has attracted a variety of organizations. These organizations also have different expectations with respect to the financial return. Some investors expect returns that compete with, and even outperform, traditional investment benchmarks, while others concede that their impact investments may deliver a lower return than that of a comparable investment that does not target social impact.[32] In addition they also have a different set of priorities with respect to social impact. The same can be said for risk. For some investors, financial returns should compete with traditional investment. Some impact investors, such as pension fund managers, are constrained by a fiduciary duty to the clients whose money they manage. These investors will have to prioritize the pursuit of a competitive financial return. Many foundations, such as the Bill and Melinda Gates Foundation, give priority to the social goal. A lower financial return is accepted.

As regards the social impact expectations, the following can be said. As there are scarcely any standards or benchmarks for social performance, investors need to use their own judgement and systems to determine whether the impact investment is making progress toward social goals. J.P. Morgan and GIIN state in their report[33] that in a survey, only 2% of surveyed impact investors reported using a third-party impact measurement system; the rest use either their own proprietary system or that used by the company in which they invest. In 2012, 96% of the survey respondents reported that they use metrics to measure social/environmental impact, leaving only 4% that do not.[34] Also, risk appetite amongst impact investors varies. Many impact investors are small organizations. They also invest in areas which carry risk from e.g. a geographical, political and legal perspective.

One can conclude that there is a wide range of investors with different sets of priorities and risk appetite.

5. Market Size

It is interesting to consider what is the market being considered here. In the field of impact investing, terminologies and investment standards are still evolving, thereby making it difficult to determine the current market size, especially given that most of the impact investing market is privately organized. But estimates suggest that the market offers the potential over the next 10 years for invested capital of USD 400 billion to USD 1 trillion.[35]

J.P. Morgan calculated the potential market size of impact investing, applying their methodology to selected businesses within five sectors – housing, rural water delivery, maternal health, primary education and financial services – for the portion of the global population earning less than USD 3,000 a year. They concluded that this segment of the market offers the potential over the next 10 years for invested capital of USD 400 billion to USD 1 trillion, and profit of USD 183 billion to USD 667 billion.[36]

6. Opportunities and Challenges

Freireich and Fulton[37] identified four factors that generated new interest and activity in what has come to be known as impact investing:[38]

– broader considerations of risk in investment decisions, triggered by the 2008-2009 financial crises. The lack of opportunities in the traditional market also attracts investors;
– growing recognition that existing resources are insufficient to address issues such as poverty, inequality and environmental issues;
– the track record demonstrating that it is possible to have business models that create financial return and social impact at the same time; and
– a new generation of high net worth individuals who would like to see their values reflected in the allocation of their capital.

In addition to these opportunities and the (future) market size, the impact investing industry has also encountered some challenges. O'Donohoe, Leijonhufvud and Saltuk,[39] as well as the website of GIIN, mention several challenges confronting impact investors:

– the absence of basic market infrastructure, such as standards for measuring and benchmarking performance, constrains impact and capital flows;
– the exacerbation of these problems by the weakness of market mechanisms such as rating agencies, market clearinghouses, syndicated facilities and investment consultants;
– the lack of clarity as regards investment opportunities; and
– the relatively small average deal size.

In the J.P. Morgan report "Perspectives on Progress: The Impact Investor Survey",[40] noted challenges include:

– the lack of appropriate capital across the risk/return spectrum;
– the shortage of high-quality investment opportunities with a track record;

30. The GIIN membership body represents a diverse group of organizations interested in deepening their engagement with the impact investing industry.
31. Harji & Jackson, *supra* n. 11, at 9.
32. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 31.
33. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 22.
34. A. Bouri et al., *Perspectives on Progress: The Impact Investor Survey* (7 Jan. 2013), at 16. *See* http://www.thegiin.org/cgi-bin/iowa/download?row=489&field=gated_download_1.
35. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 9.
36. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 11.
37. *See* Freireich & Fulton, *supra* n. 7, at 15-19.
38. Harji & Jackson, *supra* n. 11, at 4-5.
39. O'Donohoe, Leijonhufvud & Saltuk, *supra* n. 10, at 16.
40. Bouri et al., *supra* n. 34.

Diagram 3

- the difficulty in exiting investments;
- the lack of a common way to discuss impact investing;
- the lack of innovative deal/fund structures to accommodate the needs of portfolio companies;
- the inadequate impact measurement practice;
- the lack of research and data on products and performance; and
- the lack of investment professionals with relevant skill sets.

The above reflects that the industry is still in the market place building phase. This is reflected in Diagram 3.

7. Conclusion

Impact investing has attracted a variety of organizations which have different expectations with respect to the financial return. Some investors expect returns that compete with, and even outperform, traditional investment benchmarks, while others concede that their impact investments may deliver a lower return than that of a comparable investment that does not target social impact. In addition, they also have a different set of priorities with respect to social impact. The same can be said for risk. The impact investing sector is relatively young. This appears from the fact that various definitions of the term "impact investing" are being used.

In addition, the market potential is huge (estimates suggest that the market offers the potential over the next 10 years for invested capital of USD 400 billion to USD 1 trillion). Furthermore, many tools such as those to measure social impact need to be further developed, and people with the right skill set need to be trained. Whether impact investing will ultimately be successful depends on the steps that the impact investing sector makes in the forthcoming years. This will determine whether the sector will be able to scale up its activities.

Having considered the origins of the impact investing sector, the players in the market, market size, challenges and opportunities, Part II of this article will address the various (tax) incentives around the world with respect to impact investing, and will provide an overview of how governments can support this sector.

International

Jochum Zutt
and Bas Breimer*

European Court of Justice Ruling in *Wheels*: The Exemption for Management of Special Investment Funds

In the *Wheels* case, the European Court of Justice held that the VAT exemption for the management of a special investment fund is not applicable to management services provided to a UK pension fund. The Court ruled that a UK-based defined benefit pension fund does not qualify as a special investment fund. In some EU countries this decision may have a significant impact for the asset management industry as management of a pension fund was regarded as a service which could benefit from the exemption. The *Wheels* case may also put application of the exemption under pressure for other funds.

1. Introduction

On 7 March 2013, the European Court of Justice (ECJ) released its judgment in the *Wheels* case.[1] The Court ruled that management services provided to a UK-based defined benefit pension fund are subject to VAT.

2. The *Wheels* Case

Capital International Limited provided management services to Wheels, a UK-based defined benefit pension fund. Wheels took the position that the management services were fully exempt, as they should be regarded as the management of a special investment fund, which is VAT exempt under article 135(1)(g) of the EU VAT Directive.[2] The UK tax authorities did not agree with this interpretation, and Wheels lodged an appeal at the UK courts. As the UK courts considered this issue a matter of Community law, questions were referred to the European Court of Justice.

Article 135(1)(g) of the EU VAT Directive exempts the management of special investment funds as defined by Member States. It was not disputed that the services supplied to Wheels qualified as management. It was disputed whether Wheels qualifies as a special investment fund. Pension funds are not defined as special investment funds under UK VAT law.

The ECJ stated in the *Wheels* case that Member States do not have the power to select from special investment funds those which are eligible for exemption and those which are not. Rather, Member States are allowed only to define, in their domestic laws, the funds which meet the definition of special investment funds. The power to define must be exercised in compliance to the purpose of the EU VAT Directive and the principles of fiscal neutrality.

The European Court of Justice stated that the purpose of the exemption is particularly to facilitate investment in securities through collective investment undertakings by excluding the cost of VAT. It is clear that funds which constitute undertakings for collective investment in transferable securities (UCITS) within the meaning of the UCITS Directive[3] are special investment funds. These are undertakings which have as their sole object the collective investment in transferable securities of capital raised from the public. Funds other than UCITS may still benefit from the exemption if they display characteristics identical to UCITS and thus carry out the same transactions or, at least, display features that are sufficiently comparable for them to be in competition with UCITS.

3. Identical to UCITS

Based on the Directive, UCITS are undertakings the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk spreading and the units of which are, at the request of holders, repurchased or redeemed, directly or indirectly, out of those undertakings' assets. Action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value are regarded as equivalent to such repurchase or redemption.

The European Court of Justice held that an investment fund in which the assets of a retirement pension scheme are pooled cannot be regarded as identical to a UCITS, simply because it is not in fact open to the public.

* **VAT specialists in the Financial services team, Ernst & Young, Amsterdam.**

1. UK: ECJ, 7 Mar. 2013, Case C-424/11, *Wheels Common Investment Fund Trustees Ltd, National Association of Pension Funds Ltd, Ford Pension Fund Trustees Ltd, Ford Salaried Pension Fund Trustees Ltd, Ford Pension Scheme for Senior Staff Trustee Ltd v. Commissioners for Her Majesty's Revenue and Customs*, ECJ Case Law IBFD.
2. EU VAT Directive (2006): Council Directive 2006/112/EC of 28 Nov. on the common system of value added tax, OJ L347 (2006), EU Law IBFD.
3. EU UCITS Directive (1985): Council Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L375 (1985).

4. Sufficiently Comparable to UCITS

Further, such an investment fund is not sufficiently comparable to UCITS to be in competition with them. A number of characteristics differentiate them, so they cannot be regarded as meeting the same needs. In particular, a defined benefit pension fund does not bear the risk arising from the management of the investment fund in which the scheme's assets are pooled. Therefore, the fund management services provided to Wheels should be treated as taxable.

There are Member States in which the VAT exemption for the management of special investment funds is applied wider than only to UCITS, or those that are sufficiently comparable. The decision of the European Court of Justice in the *Wheels* case puts this treatment under pressure. Non-UCITS which are currently benefiting from exemption will need to pass the "sufficiently comparable to UCITS" test.[4] Special consideration should be paid to this criterion when setting up a new fund.

5. Conclusion

The Wheels case provides clarity on the VAT treatment of management services to defined benefit pension funds. This case will have a significant impact in countries where management services to pension funds were treated as exempt. Also, the Court's decision may result in discussions on the application of the exemption for management of special investment funds where other non-UCITS are involved.

4. An example of a sufficiently comparable fund would be closed-end investment trust companies. *See J.P. Morgan Claverhouse*, Case C-365/05.

Cumulative Index

