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EU Directive on Administrative Cooperation

DAC 6 Position Paper

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Introduction

This position paper was created by the International Securities Lending Association (ISLA) Tax Working Group, in conjunction with Deloitte LLP. It should be read by participants in the Securities Lending industry, who are making transactions where either one or more parties act out of the UK, an EU country, or where securities are being loaned and are issued by an EU corporate, or other entity.

Securities lending is a common financial service which provides liquidity and helps ensure the efficient functioning of equity capital markets. The current total global value of on-loan securities exceeds two trillion USD. Securities lending facilitates market making activities of financial institutions, enables short selling, increases liquidity in the financial markets and helps mitigate price volatility.

Working closely with the global industry as well as regulators and policy makers, ISLA advocates the importance of securities lending to the broader financial services industry. ISLA supports the development of a safe and efficient framework for the industry, by playing a pivotal role in promoting market best practices, amongst other things. ISLA sponsors the Global Market Securities Lending Agreement (GMSLA) and the annual enforceability review in over 65 jurisdictions globally.

Taxation and its interaction with the financial markets in which our members operate is an important area of focus for ISLA. Through specialist working groups, we respond to tax authorities on emerging tax areas, such as the EU Mandatory Disclosure Rules being introduced in all 27 EU member states and the UK, in compliance with Council Directive (EU) 2018/822, also known as DAC6.

Through DAC6, the EU is introducing an additional level of transparency in order to detect aggressive and contrived cross-border tax arrangements. Although the directive is not effective until 1 July 2020, intermediaries and taxpayers need to monitor (and potentially report) their cross-border arrangements on a retrospective basis from 25th June 2018. There is a 30-day reporting deadline which applies from 1st July 2020; however, reportable arrangements since 25th June 2018 must be reported by 31st August 2020.

ISLA has held a number of working groups on DAC6, which have been well attended by our members with representation from the borrower, lender, and lending agent communities. There is a general consensus among members that ordinary securities lending transactions are not structured with a main benefit of obtaining a tax advantage and, even if that is not the case, many participants in the lending chain will be unaware of whether any such benefit arises and, if so, to whom.

ISLA is therefore producing this position paper in an attempt to implement a consistent approach across the industry. It is acknowledged that in the case of more structured securities lending transactions a different approach might be appropriate. This position paper is intended to set out the basic position with respect to ordinary course securities lending transactions. In particular, this paper sets out the analysis with respect to whether any of the Hallmarks (see Appendix 1) might apply and whether the relevant participants would have sufficient knowledge to determine this.

ISLA supports and agrees with the conclusions of the Association of Financial Markets in Europe's (AFME) "Application of DAC6 to Financial Products and Services" paper (the AFME DAC6 paper), including the five key principles therein (see Appendix 2 for more details).

There is presently no detailed guidance from many of the tax authorities in EU Member States or the UK concerning specific financial products or securities lending. This position paper draws on the common understanding of our members and is based on discussions from our DAC6 working group, which consists of market participants. While we would welcome further dialogue with tax authorities in respect of the points raised in this discussion paper, we recognise that it may not be possible to produce detailed guidance with respect to securities lending transactions. As such, this paper is intended to be used by market participants as a common basis: a guide to interpreting if and when securities lending arrangements might give rise to a reporting obligation pursuant to DAC6.

This paper is written in a spirit of transparency and full disclosure, and ISLA intends to send this position paper to all tax authorities implementing DAC6.

Scope & Assumptions

i. All securities lending transactions discussed in this paper are between unrelated parties on arm's length terms, including pricing.

ii. Hallmark A3 is not applicable to industry standard templates such as GMSLAs, which are master agreements based on template terms with the specific transaction details being negotiated on a case by case basis and is not considered further in this paper.

iii. Hallmarks C and E generally apply to arrangements involving affiliated enterprises and so securities lending arrangements between affiliates are out of scope of this position paper, which relates to transactions with third parties.

iv. No particular issues arise with respect to securities lending transactions in the context of Hallmark D, provided that clients/counterparties provide all relevant common reporting standard (CRS) documentation. Hallmark D is therefore not considered further in this paper.

v. This position paper does not cover the more extensive Polish Hallmarks, enacted into Polish domestic law.

vi. This position paper therefore focuses on Hallmarks A2, A3 and B2 and sets out the reasons why, in the vast majority of commercial securities lending transactions entered into between third parties, there should be no requirement for any party to make any report under DAC6.

vii. This paper does not focus on the transfer of securities by the borrower to the lender by way of non-cash collateral with respect to the loaned securities. However, the position taken in this paper with respect to securities loans, should by extension generally apply equally to the provision of non-cash collateral assets pursuant to the terms of the ordinary course securities lending transaction.

viii. This paper assumes that the lending agent, the borrower and potentially the lender are intermediaries for the purposes of DAC6 reporting, although this will of course depend on their precise roles. There may also be circumstances where the lender or borrower is the relevant taxpayer, if that party would obtain any tax advantage. Clearly, where a party is the relevant taxpayer, it will have knowledge of whether a tax advantage arises and whether obtaining that advantage constituted a main benefit of entering into the arrangement. However, the rest of the analysis set out in this position paper, such as with respect to whether ordinary course securities lending arrangements should give rise to a reporting obligation, whether the Hallmarks apply and the risk of over-reporting, apply equally to these parties as relevant taxpayers as well as, or rather than being intermediaries.

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Executive Summary

1. The key position set out in this paper, reflecting the views of the majority of ISLA members, is as follows:-
   - In the event that a securities loan is structured specifically in order to obtain a tax advantage, or if it is contrived, or if any party has specific knowledge that obtaining a tax advantage is a main benefit of the arrangements, then any intermediary or taxpayer who is aware of this, will of course be required to consider whether a Hallmark applies, such that the arrangement is reportable under DAC6.

   - However, the vast majority of securities loans entered into in the ordinary course of business of lenders, borrowers and lending agents should not, for the reasons set out in this position paper, give rise to any reporting obligation. Even where a Hallmark may be satisfied by reference to other parties and subsequent transactions (where those other parties will need to consider DAC6), the parties to the lending arrangement as described in this position paper would not be expected to have any such knowledge and so should not be required to report. Were tax to be a main benefit of the transaction then it may of course be reportable by an intermediary who is or ought reasonably to be aware of the main benefit (as described in the bullet above).

   - ISLA agrees with the conclusions of, and the five principles set out in, the AFME DAC6 paper (see Appendix 2)

2. With respect to whether a cross-border arrangement arises:

   - If a transaction is not a cross-border arrangement, such as a loan of UK securities between a UK lender and a UK borrower, it will be outside the scope of the rules.

   - If a transaction does not involve an EU nexus, such as a US entity lending Japanese government bonds to a Hong Kong entity, it will be outside the scope of the rules.

   - Where a transaction is a cross-border arrangement involving a UK or EU party, it will not be reportable unless it specifically falls within one of the Hallmarks.

3. With respect to whether any cross-border securities lending arrangement satisfies a Hallmark:

   - We would not expect Hallmarks C, D or E to apply to securities lending arrangements involving third parties (not affiliates). Whether any of Hallmarks A or B apply, depends on whether:

     - the factual conditions are met for the Hallmark to apply, e.g. a fee which is calculated by reference to a tax benefit (Hallmark A2) or income which is converted into capital (Hallmark B2),

     - there is a main benefit of obtaining a tax advantage, and

     - the lender, borrower, or lending agent, as the case may be, possesses actual detailed knowledge or could reasonably be expected to have actual detailed knowledge, through its usual due diligence processes.

   - Where the factual conditions of Hallmark A or B to be satisfied and an intermediary to have actual knowledge (or it ought reasonably to have been aware) of this fact, then that intermediary should of course report. However, in ISLA's view, in the vast majority of cases the conditions of these Hallmarks should not be satisfied, as discussed in section 7 below.

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- These matters are considered further in this position paper, although no Hallmark clearly applies to securities loans absent any special facts and circumstances such as a contrived arrangement designed to obtain a tax advantage, which we do not consider would be the case for the vast majority of securities loans. There is potential that an ordinary securities lending transaction could be regarded by a fiscal authority as converting income into more favourably taxed income and therefore reportable under Hallmark B2, where a manufactured or substitute dividend is taxed more favourably than the actual dividend would have been, including with respect to withholding tax. However, this is still subject to the objective knowledge test and main benefit tests discussed below.

4. Even where any of the Hallmarks were to apply as a factual matter, and a party were to enter into the arrangement with a main benefit of obtaining a tax advantage:

   - in most cases only that party (and potentially its advisers and counterparty) would have sufficient knowledge to be considered an intermediary (or relevant taxpayer) for these purposes – the majority of other parties in the chain of lending transactions (such as a lending agent), were there to be any other parties at all, are unlikely to have actual knowledge and could not reasonably be expected to have actual knowledge, and so should not be intermediaries and should therefore have no obligation to make any disclosure under DAC6.

   - In practical terms, where market participants facilitating transactions are unaware of key factual details of whether any tax advantage is obtained or whether that is a main benefit, or when the arrangement is made available, this reflects the fact that as a technical matter, that market participant should not be an intermediary for DAC6 purposes.

   - A substantial majority of securities lending transactions result in the borrowed securities being delivered to the market to cover short sales. In these situations, the borrowed securities will generally be acquired by a third party that (i) is not known to the lender or the borrower, (ii) may have no idea the securities they have purchased were borrowed and (iii) if the securities are held over a dividend payment, will be subject to tax on that dividend in accordance with the laws of their own jurisdiction and the jurisdiction of the issuer of the underlying shares. In this situation, none of the parties involved in the securities loan will have any knowledge that the overall tax collected by the relevant jurisdictions will be more or less as a result of the loan. Consequently, there is no reason to believe that a tax advantage is expected to or does arise.

5. Securities lending is a very well-established industry, well known to fiscal authorities and subject to reporting under the new Securities Financing Transactions Regulations (SFTR). It seems unlikely the policy intent behind DAC6 is to capture the large volumes of daily flow transactions that occur between borrowers and lenders on a daily basis and effectively duplicate the reporting of securities lending transactions to regulators. If the tax authorities intend that ordinary course securities lending transactions should be reportable, then this would result in large volumes of reports and often duplicated reporting by different commercial parties involved in the transaction.

Hallmarks

There are 19 Hallmarks in total, which are split into five different categories as Hallmarks A to E. All the Hallmarks are detailed in Appendix 1 for completeness and for reference, though in practice we would not expect all Hallmarks to be relevant to ordinary course securities lending transactions.

Hallmarks C, D and E are not discussed in the following analysis as ISLA believes they are not relevant to ordinary course securities lending with third parties.

This position paper also scopes out Hallmark A1 on the basis that, in line with UK tax authority HMRC guidance IEIM642010, normal commercial wording that requires taxpayers to keep transaction details confidential from other parties, but permits the disclosure of information if required by regulators/tax authorities, should not trigger this Hallmark. This position is consistent with template securities lending agreements such as the GMSLA 2000 or GMSLA 2010.

As such, this position paper focuses on Hallmarks A2, A3, B2 and B3.

Cross-Border Arrangements

DAC6 only relates to 'cross-border arrangements' with a nexus in an EU member state (or the UK). A cross-border arrangement means an arrangement that concerns at least one EU member state and another jurisdiction (e.g. participants resident or operating through a branch or permanent establishment in different jurisdictions). If a transaction is not cross-border or has no nexus with the EU (or UK), then it is outside the scope of DAC6. It is the residence of the counterparties (or intermediaries) which is relevant, not the residence of the underlying products.

If a transaction is cross-border, market participants will need to assess if it is reportable under the DAC6 rules of the jurisdiction of one or more of the intermediaries involved in implementing the transaction, which will in turn depend if any of those intermediaries has reason to know of any tax advantage or main benefit.

Does the Borrower, Lender or Lending Agent have reason to know if the Arrangement meets a Hallmark?

DAC6 places reporting obligations on "intermediaries" or, where there are no intermediaries involved, relevant taxpayers. Intermediaries for DAC6 reporting purposes has a wider scope than just promoters, marketers, or designers of in-scope arrangements. Intermediaries, as service providers, may include:

"any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows or could be reasonably expected to know that they have undertaken to provide, directly or by means of other persons, aid, assistance or advice with respect to designing, marketing, organising, making available for implementation or managing the implementation of a reportable cross-border arrangement."

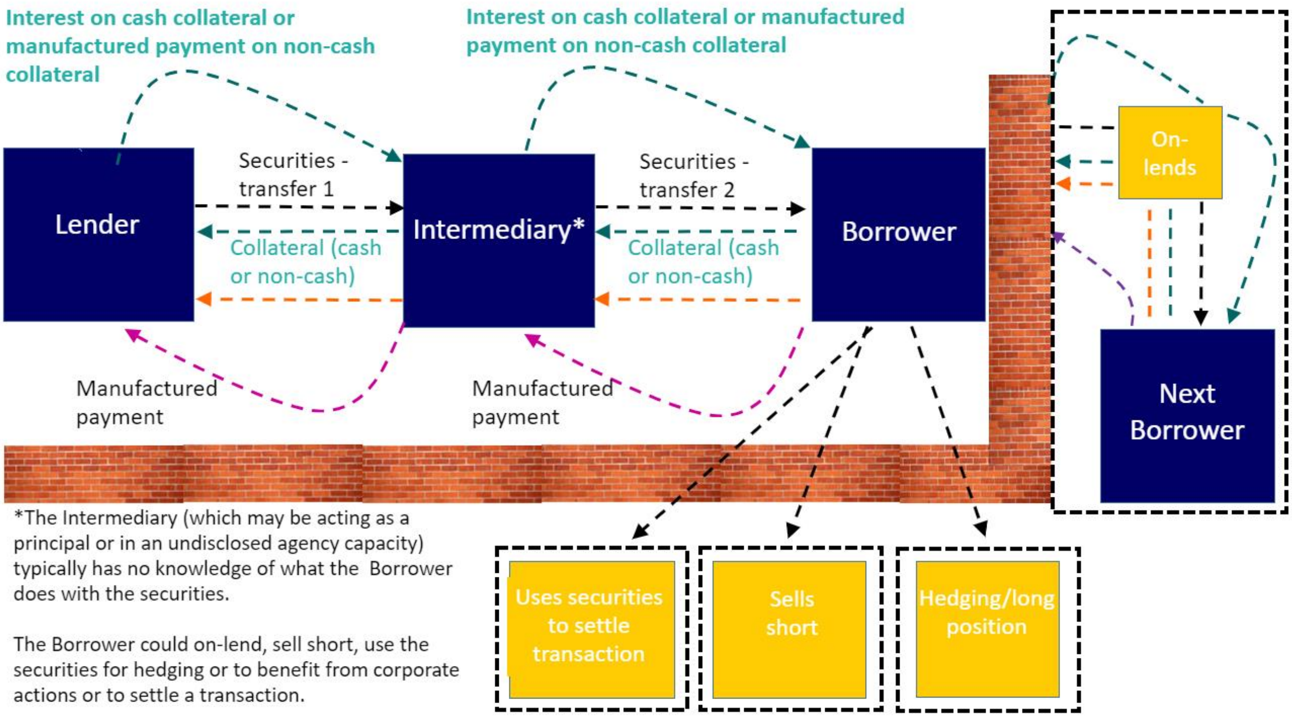
As noted by AFME, if a financial intermediary has specific knowledge concerning the tax planning of the parties to the transaction, or designs or provides a trade based on the tax attributes of the parties to the transaction, then that intermediary could be expected to assess whether a reporting obligation arises.

Recently updated guidance from HMRC states:

''Particularly in large organisations, knowledge may be fragmented. Attempting to artificially fragment knowledge so that no person has the full picture of the arrangement and therefore no one is in a position to conclude that the arrangement should be reported would not be acceptable. In such a scenario, HMRC would maintain that the intermediary should reasonably be expected to know that the arrangement was reportable.

Where there is no attempt to deliberately fragment knowledge or otherwise circumvent the rules, HMRC would not expect that all knowledge held in the organisation would necessarily be treated as known to one person. What it is reasonable to expect an intermediary to know will depend on the circumstances.''

This position paper sets out the view of ISLA's members that members are unlikely to have specific knowledge of the tax aspects in the vast majority of securities lending transactions as described in this paper. The diagram below shows the typical situation with respect to a lender and a borrower, together with the intermediary in the middle if applicable:



As described in the AFME DAC6 paper, lenders enter into securities lending transactions for a number of commercial reasons, including but not limited to:

- earning additional income from the fees paid by the borrower, making the most of their ability to earn additional income from the asset that they hold;
- obtaining financing secured against the securities they hold; and/or
- obtaining collateral upgrades from a balance sheet and liquidity perspective.

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There are many reasons why a borrower of securities may wish to enter into a securities lending transaction (also set out in the AFME DAC6 paper), including but not limited to:

- sourcing securities where a counterparty may have failed to deliver, so that the borrower may meet its own obligations to its counterparty.
- selling the security short (where the borrower hopes to benefit from a fall in the price of the security);
- for hedging purposes (i.e. selling the security short to hedge an existing long position or in order to hedge a derivative where the borrower's client takes a synthetic short position);
- on-lending to a client or counterparty which is selling short (either for them to benefit from a downward price move or to hedge a long position), or a prime broker may borrow to on lend to its own client for that client's own purposes; and/or
- to sit long and benefit from corporate actions, such as takeovers/mergers and dividends.

Financial intermediaries such as broker dealers have a central role in the securities lending industry. The bank, broker dealer or lending agent involved will often have an appreciation of the commercial rationale underpinning the securities lending transaction, as well as the relative supply and demand of a particular security, but it is less likely the financial intermediary will know the specific reasons behind the borrower or lender's decision to enter into the transaction and whether or not obtaining a tax advantage is one of the main benefits of doing so. Indeed, a financial intermediary would only know if tax is a main benefit (assuming it is not the taxpayer) if the financial intermediary specifically discusses the counterparties motivations with the counterparty or the counterparty were to notify the intermediary of its motivations.

The Main Benefit Test

For Hallmark categories A, B and certain elements of category C, an arrangement will only be reportable if it also satisfies the 'Main Benefit' test ("MBT").

"This test will be satisfied if it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement is the obtaining of a tax advantage".[1]

It is important to note that the MBT should only be met where the tax advantage is contrary to policy and a tax advantage will only arise where it is inconsistent with the principles of the relevant legislation.

In alignment with the AFME DAC6 paper, ISLA' position is that where none of the parties to a securities loan has any specific knowledge or a reason to believe that the terms of a securities loan are linked to a tax advantage obtained by a taxpayer, there should be no basis to infer that a tax advantage is a main benefit of the arrangement.

[1] Wording taken directly from the Council Directive 2018/822/EU

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Relevant Hallmarks

The Hallmarks are not mutually exclusive. The arrangements must be reported under each Hallmark that is met by the arrangement. The following paragraphs of this position paper consider the main Hallmarks which are potentially relevant to securities lending.

Members of our DAC6 working group have suggested they would like more clarity from tax authorities around Hallmarks A2 and A3. Some working group members have expressed concerns relating to Hallmarks B2 and B3 and C, although Hallmark C1 is outside the scope of the position paper, as it only arises where parties are affiliated with each other rather than being independent.

Contingent Fees & Securities Lending (Hallmark A2)

Members have expressed concern that the fee for securities lending, being an 'all-in' fee and quoted by reference to the net dividend that would be receivable by the lender, could feel or look like it is contingent on a perceived tax advantage.

- If a fee is clearly calculated by reference to or reflects a tax advantage for any party to the arrangement then any relevant intermediaries and/or taxpayers (if no EU/UK intermediaries make the arrangements available for implementation) who are aware of this or who ought reasonably to have been aware of this should consider whether Hallmark A2 applies.

- But this will not typically be the case. As the AFME DAC6 paper notes, "in the ordinary course of securities lending neither the all-in fee paid by a borrower nor the fee earned by an agent lender or lender is fixed by reference to a tax advantage gained from the securities loan, nor is it dependent on tax benefits being achieved by any of the parties to the securities loan or arrangement".

- The fee payable by the borrower to the lender in a securities lending arrangement is primarily driven by a number of market considerations including the supply, demand, and liquidity of

- particular securities – and is therefore in the first instance set 'objectively' by reference to market conditions irrespective of the identity, or tax attributes, of the parties. The price a particular borrower is willing to pay for the temporary use of a security will depend upon its other positions, whether it needs to hedge, fulfil a failed sale, go short, etc. (as discussed in section 5 above).

- Where a securities loan crosses a dividend date, the lender will wish to be compensated for the dividend it does not receive. As such, the borrow costs take into account the real dividend entitlement plus any associated withholding tax charge the lender may have suffered (some or all of which may be recoverable under a double tax treaty) had the lender retained the security in custody over the income record date. Those two amounts in addition to the simple fee for lending are commonly referred to as the "all-in" rate. However, the fact that withholding tax is a factor that is relevant to calculating this fee does not mean that the fee is linked to any tax advantage obtained by any person – rather, it is ultimately a price determined by the market.

As detailed above, the borrow fee, including an all–in rate, is not directly linked to the tax treatment of the two counterparties in the lending arrangement. It is a market-determined price, quoted by the lender to the borrower based on a number of factors including supply and demand and the general liquidity of the security at the time. In part, the all-in rate includes the rate at which manufactured dividends are paid. This facilitates evaluation by the lender of the economic value of the loan. Indeed, where securities are borrowed to create a short position, the "all-in rate" is simply a fee paid by the party borrowing the shares as a cost of going short. The borrowed shares will belong to a third party (generally unknown to the parties of the loan) that will be subject to tax on any dividends received in accordance with applicable law. The all-in rate will not reflect in any way the withholding tax suffered by that third party (which may be more or less than what the lender would have paid, had it received the dividend itself). Whilst a key component of the all-in rate is the relevant withholding tax rate, a jurisdiction applies to the payment of a dividend, withholding tax rates levied by a jurisdiction may vary depending on the type of beneficial owner receiving the dividend and their tax residence.

The factors which determine the all-in rate are aggregated across the entire market, resulting in a market-determined rate. The specific borrower will pay the market rate, not a bespoke fee linked to their own specific tax circumstances.

Therefore, prima facie, this paper takes the position that Hallmark A2 should not apply to ordinary course securities lending priced on the basis set out above (irrespective of the MBT).

Further, to be reportable under Hallmark A2, a securities loan transaction would also need to satisfy the MBT. Securities lending is an established industry and the practice of quoting an all-in fee by reference to the net dividend that would be receivable by the lender has been industry standard for many years. We understand tax authorities are well aware of securities lending arrangements and pricing methodologies and have not previously expressed any concerns. This should give comfort that it is not the intention of the legislation to capture these transactions.

It would not in our view, for the reasons referred to elsewhere in this paper, be correct for a tax authority to infer a main tax benefit solely because the all-in rate paid by the borrower to the lender includes a payment made without any withholding tax, versus the comparable transaction of a real dividend being paid (i.e. a manufactured dividend may not be subject to withholding tax when a real dividend payment would have been).

Where the lender, as a service provider, has no knowledge or a reason to believe that the fee element of the pricing is in some way derived from any tax motivated arrangement obtained by the borrower either directly or indirectly from the borrowers onwards use of the assets, it would seem unreasonable to conclude the lender would be in a position to assess the arrangement and conclude that a tax advantage was the main benefit of that arrangement (even if the counterparty did derive a tax benefit).

Standard Documentation in Securities Lending (Hallmark A3)

At first blush, a market standard template agreement such as a GMSLA could be construed as an agreement *"that has substantially standardised documentation and/or structure and is available to more than one relevant taxpayer without a need to be substantially customised for implementation."*
Where a document has been designed and standardised for use in marketing tax products or schemes, then any intermediary or taxpayer involved would have to consider whether the Hallmark is satisfied and the arrangements reportable. However, this is highly unlikely to be the case in the context of template securities lending agreements. A GMSLA is a template contractual agreement for securities lending arrangements published by ISLA. Like other common financial instruments, such as commercial loans, derivatives and repos, template agreements have been developed for use by market participants:

- in order to ensure consistent allocation of commercial and legal risks between the counterparties; and
- as a starting point for negotiations to save the counterparties time and resource negotiating the same legal terms over and over again on a transaction by transaction basis.

The key terms of a securities loan are bilaterally negotiated, and the negotiation of those terms can often take several months. Securities lending agreements based on a GMSLA should not, therefore, be considered to rely on 'standard' documentation. As HMRC say in their guidance at IEIM642030, "although there may be standard elements, the customisation for any particular arrangement may be considerable, and so the Hallmark would not be met".

Consequently, and quite apart from the MBT, this paper takes the position that the use of a template securities lending agreement such as a GMSLA, OSLA or MSLA in the ordinary course of securities lending does not constitute the use of a standardised document.

We further note that the German tax authorities have issued draft guidance to the effect that documentation will only be regarded as standardised if it is drafted with the primary intention of achieving a tax advantage. GMSLA, OSLA, MSLA agreements were certainly not drafted to achieve such an advantage, and we encourage the tax authorities of other member states to follow the German approach.

Further, it seems quite clear that any tax benefit that might be argued to arise from any securities lending transaction does not in any way emanate from the use of a template commercial agreement. Put another way, in our view it cannot be said that a main benefit of using a market template agreement such as a GMSLA is obtaining a tax benefit.

As such, the position taken in this paper is that entering into a GMSLA or similar document in the ordinary course of a securities lending business neither constitutes the use of a 'standardised agreement' for DAC6 purposes nor has a tax main benefit.

Income Converted into Capital, Gifts or Other Categories of Revenue which are Taxed at a Lower Level or Exempt from Tax (Hallmark B2)

This Hallmark has the effect of capturing any arrangement "converting income into capital, gifts or other categories of revenue which are taxed at a lower level or exempt from tax", subject to the MBT. Where parties enter into contrived arrangements designed to convert one form of income into something which is taxed at a lower level or is exempt from tax, then the intermediaries and/or taxpayers involved with sufficient knowledge would need to consider whether the arrangement is reportable. In the vast majority of circumstances this will not be the case, however.

This paper takes the position that a securities lending transaction does not involve the conversion of income into capital or more favourably taxed income. In lending securities, the parties create a whole new set of legal obligations on an arm's length commercial basis. A lender loses the right to receive the dividend, since the lender no longer holds the shares, but is entitled to receive a separate and distinct payment from the borrower to compensate. The fact that the borrower must manufacture a dividend is intended to ensure that securities loans can still be entered into over dividend dates and to ensure that the lender is not out of pocket as a consequence, not typically to convert a dividend into some other kind of payment.

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Moreover, the dividend has not been converted into anything else, it remains a dividend to be received by some other third party, such as the borrower or any onward borrower or purchaser in the market, that will likely be subject to tax on that dividend both in its own country and the country out of which the dividend has been paid (if it is not the same.)

Further, many countries' tax rules treat dividends and manufactured dividends as equivalent payments subject to the same tax treatment, in accordance with specific, and often prescriptive tax rules. We note that the taxation, whether at source or upon receipt, of dividends and manufactured dividends is often covered explicitly by the legislation of the relevant jurisdiction, such that no tax advantage should arise for the purposes of this Hallmark (e.g. see HMRC guidance at IEIM643020).

In any event, even were a securities loan prima facie to fall within the Hallmark, whether this conversion of income is a main benefit of the securities loan would depend on all the facts and whether any intermediary was aware of these facts. For the reasons described in section 5 above, this paper takes the position that a financial intermediary will typically be unaware of the motivations of third parties.

An arrangement which includes circular transactions resulting in the round-tripping of funds, namely through involving interposed entities without primary commercial function or transactions that offset or cancel each other or that have other features (Hallmark B3)
If a securities loan were structured such that it fell within this Hallmark, such as by utilising interposed entities to be circular in nature, then of course the parties would need to consider if it should be reported. However, in the vast majority of circumstances this should not be the case. A securities loan entered into the ordinary course of business does not involve offsetting or self-cancelling transactions or interposed entities with no commercial function.

Securities loans do involve the loan of securities by the lender to the borrower, and the borrower is then required to re-deliver equivalent securities to the lender in order to close out the loan. Furthermore, collateral is typically posted by the borrower to the lender, which is then returned to the borrower in the event of a default. In terms of cash settlement, there may be netting of payments due between the parties. However, none of these transactions is artificial or contrived, they all have a commercial purpose and crucially the transactions have enduring economic consequences for the parties. Put another way, no transaction is circular – the essence of a securities loan is the transfer of securities from one party to another and the ultimate return of fungible securities. But this is not circular, without commercial function or self-cancelling – rather, the borrower borrows the securities in order to benefit from being in possession of the securities and free to deal in those securities as it sees fit.

No ordinary commercial securities loan involves interposed entities. Where multiple parties are involved in a chain of lenders and borrowers each party is taking its own commercial risks and seeking its own financial or commercial rewards.

Again, the MBT must also be applied before any transactions would be reportable under Hallmark B3. For the same reasons discussed above we do not believe the intention behind DAC6 is to capture securities lending on the grounds that the flow of funds is circular.

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Avoiding Over Reporting

A stated aim of the Directive is to collect information of aggressive cross-border arrangements in line with the BEPS Action 12 report. The OECD have stated that any mandatory disclosure regime should avoid, "*over-disclosure or placing an undue compliance burden on taxpayers*". The European Council guidance is to look to the OECD as a source of illustration or interpretation of the Directive.

Securities lending is a very well-established industry, well known to tax authorities and is already subject to reporting under the OECD. It seems unlikely the policy intent behind DAC6 is to capture the large volumes of transactions that occur between borrowers and lenders on a daily basis as this would effectively duplicate the reporting of securities lending transactions to regulators.

It seems unlikely tax authorities will want to receive large volumes of ordinary course transactions that the tax authority already knows about. Reporting all securities lending transactions under Hallmark A2 would seem to result in "*over-disclosure*" and place *"an undue compliance burden on taxpayers"* as well as swamping tax authorities with data meaning that tax authorities are less able swiftly to identify those transactions they consider to be aggressive.

As such, this position paper takes the stance that ISLA members and market participants should not over-report and, in particular, should only report contrived or uncommercial securities lending transactions where the ISLA member as an intermediary has specific knowledge of, or ought reasonably to have specific knowledge of, a tax avoidance motive. The conclusions that ordinary course securities lending transactions are unlikely to be reportable under any of the DAC6 Hallmarks are consistent with the stated aim of the OECD to not over report.

GDPR considerations when reporting:

It is generally assumed by tax authorities that when an arrangement must be reported under domestic law that there is no breach in the General Data Protection Regulation (GDPR) rules. Any over-reporting, i.e. the reporting of arrangements under DAC6 that, due to a lack of clarity in the Directive might well not require reporting, but which is done in a spirit of openness due to lack of clear guidance from tax authorities, could in fact be in breach of GDPR privacy rules where there is no clear legal requirement to disclose personal details to tax authorities. We are not aware of any evidence suggesting that tax authorities have been participating in detailed alignment discussions with data commissioners.

This regulatory dissonance is an impediment to businesses seeking to enter into commercial transactions. There is therefore a need for members to balance the risks (and financial costs) of reporting a transaction under any of the Hallmarks versus contravening GDPR rules, placing market participants in a difficult position when merely seeking to carry on business and generate taxable profits. This reinforces the position set out in this paper that market participants should only report securities lending transactions under DAC6 when it is clear that a Hallmark applies and the intermediary or taxpayer in question has the relevant knowledge.

Use of this Position Paper

This position paper is intended for use as a general guide to the potential application of DAC6 to securities lending transactions entered into in the ordinary course of business with third parties on arm's length terms and should not be used as specific advice.

Where a securities lending transactions is clearly contrived, entered into on non-commercial terms and/or with only a tax motivation in mind, then any intermediary or taxpayer should clearly consider whether it is required to report the arrangement under DAC6 to its local tax authority. However, as set out in this paper, in the vast majority of cases that will not be the case.

We would always recommend seeking professional tax advice with respect to your specific circumstances.

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Appendix 1 – The Hallmarks

A. Hallmarks *- generic Hallmarks linked to the* ***main benefit test***

A1. Confidentiality - Are the arrangements to be kept confidential from a tax authority or other intermediary (only where confidentiality is related to tax advice)?

A2. Contingent Fees - is there a contingent fee linked to:

a. The amount of tax advantage?

b. A tax advantage being derived?

A3. Standardised documentation - Is there standardised documentation not requiring substantial customisation?

B. Hallmarks *- specific Hallmarks linked to the* ***main benefit test***

B1. Losses - Where a loss making company is acquired, are losses offset to reduce taxable profits, including through transfer of those losses to another jurisdiction or by acceleration of the use of those losses?

B2. Conversion - Is income converted into capital, gifts or other categories of revenue which are taxed at a lower level?

B3. Circularity - Any circular transactions resulting in round-tripping of funds, namely through involving interposed entities without other primary commercial function?

C. Hallmarks *- specific Hallmarks related to* ***cross-border transactions***

*C1. Certain deductible cross-border payments made between associated enterprises (**MBT**) - Do any of the transactions involve a deductible payment where the recipient:*

b.i. Does not impose corporation tax?

c. Has a full tax exemption?

d. Benefits from a preferential tax regime?

*C1. Certain deductible cross-border payments made between associated enterprises (**no MBT**) - Is there **a cross border deductible payment** and:*

a. The recipient has no tax residence?

b.ii. The recipient is resident in non-cooperative jurisdiction?

*C2. Double dip depreciation - Is **depreciation** on the same asset claimed in more than one jurisdiction?*

C3. Claiming double tax relief multiple times - Does the arrangement involve claiming double taxation relief in multiple jurisdictions in respect of the same income or capital?[2]

[2].

C4. Transfer of assets - Does the arrangement involve a transfer of assets where there is a material difference in amount treated as payable?

***D. Hallmarks** - specific Hallmarks relating to the automatic exchange of information and beneficial ownership*

D1. Arrangements to avoid reporting of Account Holders - Does the arrangement attempt to circumvent automatic exchange of information of Financial Account Information, including at least the following[3]:

1.a. the use of an account, product or investment that is not a Financial Account, but has similar features; and, or

1.b. the transfer of Financial Accounts or assets to, or the use of jurisdictions that are not bound by the automatic exchange of Financial Account information with the State of residence of the relevant taxpayer; and, or

1.c. the reclassification of income and capital into products or payments that are not subject to the automatic exchange of Financial Account information; and, or

1.d. the transfer or conversion of a Financial Institution or a Financial Account or the assets therein into a Financial Institution or a Financial Account or assets not subject to reporting under the automatic exchange of Financial Account information; and, or

1.e. the use of legal entities, arrangements or structures that eliminate or purport to eliminate reporting of one or more Account Holders or Controlling Persons under the automatic exchange of Financial Account information; and, or

1.f arrangements that undermine, or exploit weaknesses in, the due diligence procedures used by Financial Institutions to comply with their obligations to report Financial Account information, including the use of jurisdictions with inadequate or weak regimes of enforcement of anti-money-laundering legislation or with weak transparency requirements for legal persons or legal arrangements.

D2. Arrangements to hide beneficial owners - Does the arrangements include a non-transparent legal or beneficial ownership chain[4]:

2.a. that do not carry on a substantive economic activity supported by adequate staff, equipment, assets and premises; and

2.b. that are incorporated, managed, resident, controlled or established in any jurisdiction other than the jurisdiction of residence of one or more of the beneficial owners of the assets held by such persons, legal arrangements or structures; and

2.c. where the beneficial owners of such persons, legal arrangements or structures are made unidentifiable?

[3] The arrangement would not be 'circumventing CRS legislation' solely because it results in non-reporting.
[4] Consider undisclosed nominee shareholders or control exercised indirectly rather than by formal ownership.

E. Hallmarks – *specific Hallmarks concerning transfer pricing*

E1. Unilateral safe harbour rules - Does the arrangement include unilateral transfer pricing safe harbour rules[5]?

E2. Transfer of hard to value intangibles - Does the arrangement involve the transfer of hard-to-value intangibles. The term "hard-to-value intangibles" covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises:

2.a. no reliable comparables exist; and

2.b. at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer.

E3. Intragroup cross-border transfers of functions - An arrangement involving an intragroup cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT), during the three-year period after the transfer, of the transferor or transferors, are less than 50 % of the projected annual EBIT of such transferor or transferors if the transfer had not been made[6].

[5] Advanced pricing arrangements ("APAs") made between tax authorities and companies or groups do not constitute unilateral safe harbours.

[6] In calculating post-transfer EBIT, where a transferor entity would be projected to make a loss if the transfer did not go ahead and, as a result of the transfer, the loss is projected to be nil, Hallmark E(3) will not be in point.

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Appendix 2 – 5 Principles of the AFME Application of DAC 6 to Financial Products & Services

Principle One: Reliance on Reasonable Procedures

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

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

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

Principle Three: Policy Contravention Requirement

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

Principle Four: Revenue Loss Requirement

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

Principle Five: Relative Materiality

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

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