Harmonisation of Tax Processing Discussion Note

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1. Introduction

This paper is a follow-up to an earlier draft analysis "The Fiscal Status of Market Claims – Discussion Note" that was presented at the meeting of the T2S Harmonisation Steering Group (HSG) on 9/10 June 2016, and that looked specifically at market claims that relate to dividends paid on equities (see Annex).

Following the request made during the discussion at the HSG meeting, the current paper is an attempt further to develop the analysis on the issue. In particular, this paper covers tax problems related to dividend payments with respect to both stocks and flows (i.e. to payments on booked securities positions, and to market claims on pending securities transactions).

Building on the conclusions of the previous paper, and on separate work relating to withholding tax procedures, this paper sets out a number of T2S community proposals to the European Commission groups working on the related topics within the Capital Market Union (CMU) agenda such as the European Post Trade Forum (EPTF) and the Expert Group on barriers to free movement of capital.

The proposals in this paper are intended to build on the work of the Corporate Actions Joint Working Group (CAJWG). In the 2012 version of the Market Standards for Corporate Action Processing, the CAJWG included the following text:

The CAJWG examined the question of the fiscal status of the cash Market Claim of a Pending Transaction impacted by a Cash Distribution and consequently the exact cash amount applicable for the Market Claim. Uncertainty remains regarding the exact moment of transfer of ownership from a fiscal point of view and different approaches co-exist in Europe. The CAJWG has identified this fiscal issue but acknowledges its limitation of competence and would recommend referring it to the FISCO group (Giovannini Barrier 11). The CAJWG believes that efforts to improve consistency and common fiscal treatment across markets and countries are essential to reap the full benefit of the EU financial market integration. The preferred solution of the CAJWG is that the default withholding rate applied to Market Claims should be determined by the Issuer (I)CSD.

2. Tax Processing on Stocks

2.1 Description of Parties

The main parties involved in withholding tax processing are all the parties in the issuance and custody chain that connects the issuer with the investor, as well as the tax authorities in the country of the issuer, and (accessorily) the tax authorities in the country of the investor.

A typical issuance and custody chain will include the following parties:

- Issuer
- Issuer Agent
- Central Securities Depository
- Sub-custodian
- Global custodian
- Custodian
- Investor (sometimes termed end investor)

When an issuer distributes income on a security (i.e. pays a dividend on equity, or pays interest on a bond), the cash will be passed on through all the entities in the chain, and each entity will have to effect related processing.

Typically, one party in the chain will act as *tax withholding agent*, and will deduct an amount of tax from the payment, and will pay this tax to the tax authorities in the country of the issuer.

2.2 Tax Withholding Agent

Depending on their characteristics and country of residence, different investors may be entitled to receive the income payment after deduction of different rates of withholding tax.

Accordingly, and in order to deduct the right amount of tax, withholding agents need to receive information both on the identities and/or categories of end investors and on the amount of securities that they hold.

In many cases, the tax withholding agent is not able and/or is not allowed to deduct tax at different rates, so that the agent withholds the tax at a single standard rate, and passes the tax to the tax authorities.

In such a case, the investor who is entitled to benefit from a lower withholding rate will have to introduce with the tax authorities a request to reclaim the excess tax withheld. Such a reclaim request will include information on the identity and/or category of the end investor, on the amount of securities that were held, and on the amount of tax that had been withheld.

2.3 Information Challenge

The main challenges in tax processing are challenges relating to information management and transmission.

In order to ensure that for a given income payment the correct amount of tax is withheld, the information that may need to be maintained and transmitted falls into four basic categories:

- information as to the identity and tax status of the investor;
- documentary evidence/proof of this tax status;
- information as to the securities held by the investor (and possibly the related information as to the amount of income paid, and the amount of tax withheld);
- documentary evidence/proof of these securities positions (and any related payments).

The starting point for management and transmission of this information is the end investor. It is the end investor that knows its identity, knows the amounts of securities it has purchased, and can receive certifications as to its tax status from the tax authorities in its own country.

With relation to the transmission of information, the two basic questions are (i) to which entities in the issuance and custody chain, or elsewhere, does the information have to be transmitted, and (ii) whether the information is transmitted using the chain, or whether entities in the chain can be by-passed so that information is transmitted directly to the relevant parties.

2.4 Relief at Source Procedures

For relief at source procedures, it is necessary that information be transmitted to the tax withholding agent.

For relief at source procedures, it is necessary that information be transmitted along the issuance and custody chain, as each entity in the chain needs to be able to process the payments correctly, and thus needs to have appropriate tax-related information.

In its 2009 Recommendation "on withholding tax relief procedures" (the 2009 Recomendation)[1], the European Commission suggested that entities lower down the custody chain could act as "information agents". Information agents could take a role of

1 COM(2009/784/EC): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32009H0784

verifying an investor's entitlement to tax relief, and could store the documentation it had received. This would mean that an information agent would pass on up the chain only "pooled tax rate information". Such a process would mean that only the information that is strictly needed for processing purposes is passed on up the chain to the withholding agent. In the same document, the Commission also suggested that the information agent that is closest to the end investor act as withholding agent.

These two suggestions would have the effect of minimising the requirement to pass on information up the chain of issuance and custody chain.

2.5 Tax Reclaim Procedures

For tax reclaim procedures, it is necessary that information be transmitted to the tax authorities in the country of the issuer.

In theory, it would be possible for an end investor to submit a reclaim request form, and supply appropriate documentation, directly to the tax authorities. In many cases, however, tax authorities require that such forms and documentation be submitted by a domestic intermediary (i.e. typically the sub-custodian) acting on behalf of the end investor. In such a case, the information and documentation would typically be transmitted along the custody chain to the sub-custodian.

2.6 Simplification of Documentation

A major aspect of the information challenge in tax procedures is the great diversity and multiplicity in application forms, and in documentation and information requirements, across Member States. The complexity in documentation requirements magnifies the complexity in information management and transmission.

Here is an example that illustrates this point. If an investor invests in ten securities from each of ten separate countries, then at a minimum the investor will have to comply with ten different sets of evidentiary requirements. If in each of these countries the issuer agent acts as withholding agent, then conceivably the investor may have to provide one hundred originals of a certificate of tax residency issued its national tax authorities.

It should be noted that in the 2009 Recommendation, the European Commission has strongly suggested that member states simplify and streamline documentation requirements.

2.7 Timing

Another significant aspect of the information challenges in tax procedures is the set of requirements deriving from the Market Standards for Corporate Actions Processing.

These standards include a requirement that the payment date for a distribution of income be as close as possible to the record date[2] and be preferably the day after the record date. As income payments are distributed to the holders of the security as of record date, this timetable places great demands on the information transmission process so as to allow correct payments to be effected on payment date.

[2] Record date is the date on which positions are struck at the end of the day to determine the parties who are entitled to the Corporate Action as well as the size of their entitlement.

3. Tax Processing on Flows

Processing on flows (i.e. relating to transactions that are pending as of, or around, record date) involves the re-allocation of the cash that is received from an income event; the initial distribution of income is based on securities holdings as fixed on record date; this income can be re-allocated through the processing of market claims.

Such re-allocations have two important characteristics. They are first of all retro-active, as they take place after the fixing of the entitlement based on positions as of record date, and – according to the Market Standards – can take place up to twenty business days after record date.

Secondly, they are not visible to all parties in the chain, as market claim processing can take place at the CSD, but it can also take place in the books of other intermediaries down the custody chain (in the event of internal settlement in the books of an intermediary between two of its clients).

Such re-allocations present two major operational challenges.

First, if a market claim represents a taxable dividend, and if the cash amount to be received or delivered by the end-investor depends on the tax status of the end-investor, then the entity processing the market claim may have to adjust the cash amount of the market claim.

If the cash amount to be debited from the deliverer is different from the cash amount to be credited to the receiver, then in addition the entity processing the market claim has to pay, or reclaim, the cash difference to, or from, the tax authorities.

Second, and again if a market claim represents a taxable dividend, then there can be the risk of an undue creation of a taxable dividend. All entities in the custody chain need to have operational procedures in place to minimise this risk. More information on these two challenges is given in the Annex.

These characteristics and challenges have meant that market claims processing is one of the most controversial and difficult parts of corporate actions processing, both from the perspective of drafting market standards, and from the perspective of the tax authorities.

4. AG Proposals for further consideration

The analysis set out in this paper suggests several steps that can be taken to improve, simplify and harmonise market claim processing.

Three important steps could be:

1. To treat market claims on dividend payments as indemnities
2. To eliminate the use of ex and cum indicators.
3. To take further the work of simplifying and harmonising the documentation, evidentiary, and information transmission requirements relating to tax relief processes

4.1 Proposal 1: Market claims as indemnities

A first important step would be to treat all market claims on dividend payments as indemnities rather than as taxable dividends. Currently, market claims on dividend payments are treated in some countries (such as ES, IT and NL) as indemnities, while in others (such as BE and DE) they are treated as taxable dividends. There is also currently the risk that a market claim on a given income payment may be treated as a taxable dividend by one jurisdiction, and as an indemnity by another jurisdiction (for example, the jurisdiction of an investor CSD).

Treating all market claims as an indemnity offers the benefits both of harmonisation, and of the prospect of simplifying operational processing while minimising operational and other risks.

4.1.1 Potential Benefits

Treating market claims as an indemnity creates the possibility that all market claims relating to a given dividend payment are calculated at the same rate, so that cash amounts that are debited and credited are independent of the tax status of the end investors involved.

Treating market claims as an indemnity would also eliminate the current anomaly in operational processing whereby a *resource* (namely, a taxable dividend) is transferred without the resource being explicitly recorded in the accounting systems of all the parties involved in the transfer.

To explain this previous point in more detail:

Throughout the custody chain, standard practice is for resources (such as cash, securities positions, subscription rights, etc.) to be explicitly recorded in the accounting systems of all the entities in the chain. This has many advantages, as it allows for visibility, for the possibility of reconciling positions through the chain, and for the possibility that when a

position in a resource is transferred from one party to another party there is an explicit and automated check that the deliverer has a sufficient position in the resource to make the delivery.

Currently, when a market claim that represents a taxable dividend settles, there are two separate resources that are transferred from the deliverer to the receiver. One resource is an amount in cash; the other resource is a taxable dividend (on which tax has been withheld). In this case, the receiver of the market claim has the ability – depending on its tax status – to reclaim an amount of that tax from the tax authorities. The *cash resource* is explicitly recorded in the accounting systems of the entities in the custody chain, and is fully reconcilable. The *tax dividend resource* is usually not explicitly reflected in the accounting systems of the entities in the custody chain, so that there is less visibility, and it is more difficult to reconcile positions through the custody chain.

This situation creates risks. First, there is risk for a delivering party in that a market claim may settle even though there is an insufficient position in the "taxable dividend" resource (i.e. the fact of having previously received a taxable dividend). Second, there is risk for the receiving party in that it may believe in good faith that through the settlement of the market claim it has received a taxable dividend, even though the delivering party did not have such a resource to deliver.

A useful comparison is with voting rights. Currently, voting rights are not explicitly recorded in accounting systems, and the Market Standards for General Meetings do not foresee any market claim process for voting rights.

Treating market claims as an indemnity would also have a third operational benefit, in that it would avoid some of the operational complexities that the buy-in obligations under CSD Regulation (CSDR) will bring about.

To explain this last point in more detail:

For transactions that have failed to settle after a number of days after the intended settlement date (ISD), CSDR places a mandatory obligation on the receiver of the securities to execute a buy-in. However, the Market Standards for Corporate Actions Processing include a requirement that market claims settle independently from the underlying transaction. This creates the possibility that a market claim settles even though the underlying transaction is subsequently bought-in, and thus subsequently canceled. If such a case occurs, and if the market claim represents an *indemnity* (i.e. simply a cash amount), then there is no particular problem as the cash compensation amount deriving from the buy-in can be adjusted to take into account the market claim amount.

However, if such a case occurs, and if the market claim represents a *taxable dividend*, then there is the potential for significant complexity and risk, especially in the case of chains of transactions, and in the case that the market claim settles legitimately (as each party in the chain did receive a taxable dividend that it was able to pass on). For example, if the underlying transaction is canceled, then the usual practice based on the existing corporate action standards would be for the market claim to be reversed, but this may no longer be possible.

4.1.2 Potential Consequences

Treating market claims as an indemnity does not in itself eliminate all complexity. There is still the scenario where the buyer and the seller may have different tax statuses, so that there may be a differential impact on buyer and seller.

Four potential consequences of treating market claims as an indemnity can be identified.

1. The first is the risk that a buyer who receives a market claim may derive less benefit from an indemnity than from a taxable dividend. This could occur if the indemnity amount is calculated using a rate that is less than the dividend amount after deduction of tax at the most advantageous tax treaty rate. Such a situation would not be acceptable, as in many such cases an innocent party, who was not responsible for the late settlement, would suffer. This problem could be resolved by setting the indemnity rate sufficiently high so that no end investor suffers.
2. The second is the risk that a buyer who receives a market claim may derive considerably more benefit from an indemnity than from a taxable dividend. This could occur if the indemnity amount is calculated using a rate that is much higher than the dividend amount after deduction of tax. Such a situation creates an incentive for the buyer to delay settlement of the underlying transaction, and to receive the indemnity rather than the taxable dividend. In such a case, the seller would be disadvantaged. Accordingly, and in order to prevent market disruption, there is a need for sellers to be protected. This problem could be at least partially resolved by setting the indemnity rate sufficiently low so that the incentive for the buyer is minimized. It may, for example, be possible to deal with the first and second consequences by fixing the indemnity amount so that it is equal to the gross dividend after deduction of tax at the most advantageous tax treaty rate.
3. A third potential consequence relates to netted CCP transactions. If by the end of record date a transaction is only partially settled, then some buyers will receive a

taxable dividend (relating to the settled part of the CCP transaction), while other buyers will receive an indemnity; a CCP participant will need to have a clear rule as to how to allocate the proceeds between its clients; in addition, the CCP participant will need to ensure that it informs its clients appropriately as to what the client has received (namely, either a taxable dividend or an indemnity). (It should, however, be noted that a rule to allocate failed transactions is needed not simply for market claims that are indemnities, but also potentially for other reasons).

4. A fourth potential consequence relates to the fact that the tax system applicable in the country of the investor may treat dividend payments and indemnity payments in a different manner. However, this problem already exists today (given that some countries treat market claims as indemnities, and others as taxable dividends). Indeed, a process of harmonization of the fiscal treatment of market claims in the country of the issuer will encourage the harmonization of the fiscal treatment of market claims in the country of the investor, especially as in many cases the country of the issuer is the same as the country of the investor.

4.2 Proposal 2: Eliminate the use of ex and cum indicators

A second possible step would be to eliminate the use of ex and cum indicators. As described in the previous paper, ex and cum indicators are powerful tools that allows for a dividend payment to be allocated to the right party, in the event of either non-standard trading activity or the use of a non-standard settlement cycle.

The rationale for the use of ex and cum indicators is based on two main factors:

- if there are large volumes of non-standard transactions, then there is a justification for a centralized mechanism that automatically reallocates the dividend payment (and thus avoids or reduces manual processing);
- if market claims represent taxable dividends, then it is important that the re-allocation process be as visible, and as reconcilable, as possible; this is especially the case in the event of non-standard trading or settlement activity; the use of ex and cum indicators allows in most cases for the re-allocation of the taxable dividend to be recorded at the CSD level.

However, major market participants currently report that the volume of use of ex and cum indicators is very low.

If market claims represent indemnities, then there would be no particular requirement for

visibility through the custody chain; a payment of an indemnity is simply a cash transfer between two parties; there is no particular consequence on third parties such as the tax authorities in the country of the issuer.

In consequence, if all market claims on dividend payments become indemnities, then a good part of the rationale for the use of ex and cum indicators disappears.

As the logic involved in the processing of ex and cum indicators is complex, eliminating the use of the ex and cum indicators would tend to reduce cost and operational risk for intermediaries and market infrastructure.

It is to be noted that ex and cum indicators are not currently used for interest payments.

These considerations tend to push in the direction of eliminating the use of ex and cum indicators.

However, the use of ex and cum indicators is codified in the existing market standards documents, namely the Market Standards for Corporate Action Processing and the T2S Corporate Action Sub Group Standards, and these standards are currently widely applied. In consequence, there may not necessarily be specific harmonisation benefits in eliminating the use of ex and cum indicators.

In addition, some of the doubts as to the legitimacy of the use of ex and cum indicators will be quelled if market claims on dividends represent indemnities.

4.3 Proposal 3: Simplifying documentation and information transmission

A third important step is to continue the process of simplifying and harmonising documentation and information transmission requirements with respect to tax relief on record date positions.

The apparent inefficiencies in the current process, and European Commission documentation on the topic, suggest that there is a major scope for savings.

Proposals one and two are fully compatible with proposal three, and indeed facilitate proposal three. In particular, proposal one ensures that entitlements to tax benefits are fixed on record date, based on record date holdings, and are not subsequently modified.

5. Conclusions and Next Steps

This paper suggests that there is a strong case for the harmonisation of the fiscal status of market claims so that all market claims on dividend payments are treated as indemnities, and not as taxable dividends.

This paper suggests that there is a case for the elimination of the use of ex and cum indicators, but this case is less strong.

This paper stresses the importance of the work to simplify and harmonise documentation and information transmission requirements with respect to tax relief on record date positions.

5.1 Next Steps

The AG members invite the HSG chairman to share these proposals with the European Commission expert group on post-trade matters, the European Post Trade Forum.
The proposals should also be sent to the Corporate Actions Joint Working Group.

6. Annex: The Fiscal Status of Market Claims - Discussion Note

1/ Introduction

At the meeting of the T2S Harmonisation Steering Group (HSG) on 26/27 January 2016, there was a discussion relating to the usage of « cum/ex » indicators for the generation of market claims.

The discussion concluded that there were broader issues than simply the question of compliance with the T2S CASG standards, and that the topic would be re-discussed at the HSG meeting on 9/10 June 2016.

This note has been prepared in order to provide some context for this discussion. It is not intended to represent the views of any institution or body.

2/ Scope – Market claims on taxable dividend payments

This paper looks specifically at market claims that relate to dividend payments that are subject to dividend withholding tax in the country of the issuer of the security.

It does not cover the full set of issues relating to dividend payments, and withholding tax relief, on booked positions as of record date.

It does not cover taxable interest payments. Some of the issues relating to taxable payments of interest on bonds are similar to the issues relating to taxable payments of dividends on equities. But there are also significant differences, such as in the market conventions for generating market claims on bond interest payments, in the frequency of problems (as most bond interest payments are paid gross of withholding tax), and in the existence of specific mechanisms in some countries (notably, Belgium and Italy) for handling tax processing on bond interest payments.

3/ Description – Distribution of taxable dividends

Typically, issuers, or paying agents acting on their behalf, distribute dividends to the holders of securities on accounts at the issuer CSD as of close of business on the day that has been fixed as the *record date* for that dividend payment.

Most dividend payments on equities are subject to withholding tax in the country of the issuer of the security.

The entity responsible for withholding the tax varies country by country. In some countries, the paying agent acting on behalf of the issuer is the withholding agent; in other countries, the withholding agent may be the CSD, or the CSD participant.

The specific rate of withholding tax that should be applied may vary by category of investor. Although many investors may have the right only to receive the dividend after deduction of a standard rate of withholding tax, some investors, such as investors located in a country that has signed a Double Taxation Agreement (DTA) with the country of issuance, may have the right to benefit from a reduced rate of withholding tax.

There are two basic mechanisms to manage the possibility that different investors should the right to different rates of withholding tax.

One mechanism is that all investors receive a dividend payment after deduction of withholding tax at a standard rate; investors that have the right to benefit from a reduced rate may then apply, in many cases to the tax authorities of the issuance country, for a repayment of the excess tax (a “tax reclaim” process).

An alternative mechanism is for information as to the tax status of the end investor (plus any relevant documentation) to be provided in advance of the dividend payment to the withholding agent, so that the withholding agent can withhold the tax at the correct rate (a “relief at source” process).

4/ Description – Market claim process

In parallel to the process of distribution of a dividend payment, there is also a market claim process.

The market claim process exists because there is the possibility that a record date holder of a securities position is not actually entitled to receive the dividend payment; this would occur, for example, if the record date holder had previously sold the securities position together with the right to the dividend payment.

The market claims process takes a *trading perspective*; it identifies who from a trading perspective is entitled to receive a dividend, and adjusts accordingly the outcome of the dividend distribution process, which is based on a *settlement perspective*.

The market claims process is based on two mechanisms. There is the standard mechanism which is based on the ex-date of a dividend payment (with the ex-date being defined as the first day of

which trading occurs without the right to the dividend payment). This mechanism looks at the trade date of a transaction; it identifies if the trade date of a transaction either is before, or is on or after, the ex-date of a dividend payment; the mechanism then looks at the real settlement date of the transaction; if the party entitled to the dividend based on the comparison of ex-date and trade date is not actually the record date holder, then a market claim will be generated.
The European standards (Market Standards for Corporate Actions, and T2S Corporate Action Sub Group Standards) also set out an alternative mechanism, which uses three indicators that can be included in a settlement instruction, namely the “ex”, “cum” and “opt-out” indicators. These indicators specify that the logic set out in the standard mechanism for generating market claims should not be used, and that an alternative logic should be used. Specifically, the “ex” indicator indicates that a transaction that has a trade date before ex-date has in fact been traded without the right to the dividend; the “cum” indicator indicates that a transaction that has a trade date on or after the ex-date has in fact been traded with the right to the dividend; the “opt-out” indicator indicates that no market claim should be generated.
The two market claim mechanisms are designed to cover three basic scenarios:
(i) a transaction that has been traded using both the standard ex-date convention and the standard intended settlement cycle (T+2), but that settles late;
(ii) a transaction that has been traded using the standard ex-date convention, but that uses a non-standard settlement cycle; and
(iii) non-standard trading activity (such as portfolio transfers, or trading “cum” on or after ex-date).
The two market claim mechanisms provide a comprehensive tool to manage such scenarios, and combinations of such scenarios.

5/ HSG discussion topic – Fiscal status of market claims

Currently, the fiscal status of market claims differs country by country.
In some countries, a market claim is considered to be a *taxable dividend*; in other countries, a market claim is considered to be a *compensation payment*.
The rationale for treating a market claim as a taxable dividend is largely based on scenario (i) above.
Under such a scenario, and if a market claim is considered as a taxable dividend, then the buyer is placed in a situation which is identical to the situation in which it would have been if the transaction had settled on intended settlement date. Specifically, the buyer is entitled to receive the dividend at the correct rate based on its tax status, and so, for example, is entitled to reclaim any excessive withholding tax.
By contrast, and if the market claim is considered as a compensation payment, then a buyer under scenario (i) may – through no fault of its own - suffer a different outcome. The buyer would have no possibility to reclaim any excessive withholding tax with respect to the market claim; in addition, there may be tax implications for the buyer in the country of the buyer, as the tax authorities in the country of the buyer may treat dividends differently from compensation payments.
Although treating a market claim as a taxable dividend has apparent advantages, there are also major challenges.

6/ Challenge – Undue creation of taxable dividends

If a market claim is treated as a taxable dividend, then there is the risk that there is undue creation of a taxable dividend.
An undue creation of a taxable dividend would occur if a market claim transfers a taxable dividend from a seller to a buyer, but that seller did not have a taxable dividend to deliver. Such a situation would be problematic as the buyer may in good faith apply – based on its tax status – for a reclaim of withholding tax, even though no tax had been withheld, as there had been no underlying dividend payment.
The risk of such a situation occurring exists under several different scenarios. One possible scenario is the case in which a trading party with a flat position sells an equity position on ex-date minus 1 (i.e. sells a position with the right to the dividend attached, and then covers its short position on ex-date (i.e. buys back the position without the right to the dividend); such a scenario is conceivable even if both transactions follow the standard settlement cycle.
Another possible scenario is the case in which a trading party with a flat position buys a position on or after ex-date without the right to the dividend (i.e. a standard transaction for which no market claim is generated), and then sells the position in a trade which includes the right to the dividend (i.e. a “cum” transaction that would settle using the “cum” indicator, so that a market claim would be

generated transferring a dividend from the seller to the buyer).
Under both scenarios, and if the transactions and the market claims settle, then there is an undue creation of a taxable dividend.
The challenge, with which CSDs and all intermediaries in the custody chain are faced, is to ensure that, when an end investor delivers a taxable dividend to a counterparty using the mechanism of a market claim, the end investor has indeed previously received a taxable dividend.

7/ Challenge – Operational complexities

There is a major operational challenge associated with market claims if the cash amount received or delivered by the end investor in the form of a market claim should vary depending on the tax status of the end investor. This could, for example, be the case for fiscal systems that treat market claims as taxable dividends, that operate relief at source systems, and that have the possibility of differential tax rates depending on the tax residency of the end investor.
To adjust the amount of a market claim depending on the tax statuses of buyer and seller is complex in the closed environment of a single national CSD; it is much more complex in an environment with cross-CSD settlement, i.e. in the case of a buyer and a seller that use different CSDs, as can be the case on the T2S platform.
To minimise such complexities, the T2S Corporate Action Sub Group standards specify that all market claims on T2S that relate to a given dividend payment should be generated at exactly the same rate.
This rule facilitates the generation and settlement of market claims on T2S. But it does not in itself provide a solution to the underlying fiscal problem which is that – in the case of a market claim that is a taxable dividend, and for both relief at source and tax reclaim systems – there is a need for an operational mechanism that ensures the correct final fiscal outcome for both buyer and seller.
In the context of T2S, we have today multiple, different operational mechanisms, each based on different national rules, that try and achieve this objective.
In the context of T2S, the fundamental challenge for both CSDs and intermediaries is not simply managing one complex mechanism; it is managing multiple, different, complex mechanisms relating to settlement on one settlement platform.
The difficulties in managing multiple, different, complex mechanisms for the fiscal treatment of market claims may have consequential effects on other aspects of processing on T2S. For example, steps that CSDs and intermediaries may choose to take could include the segregation of securities accounts by the tax status of the end investor, and the creation of separate securities account structures based on the national tax status of the securities held on the accounts.

8/ Some Provisional Conclusions

1/ There is a broader discussion than simply the discussion of the use of “ex”, “cum” and “opt-out” indicators.
2/ Even if these indicators were no longer used, there would still be underlying problems and challenges relating to the fiscal status of market claims.
3/ The use of these indicators creates the possibility for appropriate market claims to be centrally generated for all types of market activity. If these indicators were no longer used, there would be the risk that it would no longer be possible centrally to generate appropriate market claims for some types of activity.
4/ There are important national divergences of practice with respect to the fiscal status of market claims, and to the operational processing around market claims.
5/ In the context of T2S, CCPs, CSDs, CSD participants, and other intermediaries may have to manage very diverse practices relating to the fiscal status of market claims, and may apply many different solutions.
6/ The discussion of the fiscal status of market claims is linked to other T2S harmonisation activities, including, most notably, activity 20 relating to withholding tax procedures. If one looks beyond the narrow scope of market claims relating to cash trades in equities, then there are also linkages with T2S harmonisation activity 14 relating to restrictions on omnibus accounts (as there is a specific discussion relating to the Belgian X/N system for withholding tax on payments of bond interest) and with prospective COGESI work on processes relating to interest payments during the life of a repo.