2010 Update to

"The UK Taxation Treatment of Insurance-Linked Securities"

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Supplementing Chapter 24 in "Insurance-Linked Securities",

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A. **Introduction**

1. The collapse of Lehman Brothers in the Autumn of 2008 resulted in a number of consequences for the insurance-linked securities market. Four catastrophe bond transactions (namely, Willow Re Ltd., Ajax Re Ltd., Carillon Ltd. and Newton Re Ltd.) were directly affected by Lehman Brothers' collapse owing to Lehman Brothers Special Financing ("**LBSF**") acting as the total return swap ("**TRS**") counterparty on those transactions.

2. The role of the swap counterparty was an important structural feature in these transactions. The swap counterparty was to make payments to the SPV issuer equal to the scheduled interest and coupon payments on the catastrophe bonds and, ultimately, the principal of the catastrophe bonds at maturity. The sudden collapse of LBSF as swap counterparty in conjunction with significant market dislocation was not contemplated in the transaction documentation; indeed, the transaction documentation had not prescribed any remedies for sponsors or investors in the event that a replacement swap counterparty could not be found in such circumstances.

3. In September 2008, each of the ratings for the four catastrophe bond transactions where LBSF was acting as swap counterparty were placed on "credit watch" and their ratings subsequently lowered, reflecting the rating agencies' view that an interest payment shortfall for each of the underlying transactions was imminent as the Lehman Brothers holding company filed for bankruptcy.[3] It proved impossible to locate new swap counterparties following that bankruptcy filing, resulting in the exposure of investors to the investment risk related to the assets in the collateral account. The absence of any replacement swap counterparty has been attributed to market participants who could have filled this role being reluctant to accept the assets in the transaction portfolios or to commit to payment of the full principal amounts at maturity of the transactions given uncertainty about the market value of the portfolios of the affected trasanctions.[4]

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3 Source: "*Clarifying the Framework for Rating Natural Catastrophe Bonds*": Standard & Poors, 26 November 2008.

4 For example in respect of the Willow Re Ltd. transaction, the assets comprised a diversified pool of mortgage-backed securities except for two assets, Long Beach Mortgage Loan Trust, Series 2006-7 and Series 2006-8, both

4. Accordingly, the collapse of Lehman Brothers ensured that any gap between market value and return on the underlying collateral on the one hand, and the obligation of the SPV issuer to meet principal and interest obligations on the notes on the other hand, had serious consequences. With the affected transactions suffering from the absence of a swap counterparty and with the default of the SPV issuers to meet scheduled payment obligations, the ratings on the notes issued were lowered to default status, the underlying collateral was liquidated and the notes subsequently unwound.

5. In addition to raising concerns regarding the role of the swap counterparty in catastrophe bond transactions, the collapse of Lehman Brothers highlighted certain potential difficulties with the collateral packages which had been utilised in the transactions where LBSF had acted as swap counterparty. The concerns regarding the collateral packages which had been established included:

   (i) a perceived lack of transparency regarding investments held in the collateral accounts;

   (ii) an absence of diversification in respect of certain underlying investments in the collateral accounts, leading to unwelcome asset concentrations;

   (iii) over-broad investment criteria for assets in the collateral account when viewed as a whole;

   (iv) some assets held in the collateral account had a longer maturity than the catastrophe bonds[5] which introduced market value risk where a sale of collateral was required to repay principal on maturity of the catastrophe bonds; and

   (v) an absence of equalisation, or "top-up", provisions for the swap counterparty if the value of the assets in the collateral account fell below a pre-determined threshold.

6. The difficulties encountered following the collapse of Lehman Brothers led market participants to evolve a number of different collateral solutions for utilisation in catastrophe bond transactions. In this supplement to Chapter 24, we have considered the UK taxation consequences of each of these varied collateral solutions in turn, paying particular attention to the collateral solutions which have utilised a Global Master Repurchase Agreement ('GMRA') during 2009 and 2010.

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of which were themselves downgraded. ("*Testing Time for Catastrophe Bonds*", Insurance ERM, 28 November 2008).

5 Some collateral for catastrophe bonds where Lehman Brothers acted as swap counterparty evidenced a notable disparity with the term of the catastrophe bonds (such as collateral assets with a thirty year maturity against catastrophe bonds with a three year maturity).

B. **Variations regarding the swap counterparty**

Certain transactions have continued to utilise a TRS collateral structure but with improvements such as more restrictive investment guidelines and a renewed focus on the credit quality of the collateral assets (including, for example, requirements to hold government-issued or government-guaranteed assets), equalisation or "top-up" arrangements in the event of a swap counterparty insolvency or default, and regular fair value/market-to-market valuations.

The existence in the market of three-year debt guaranteed by the US Federal Deposit Insurance Corporation and issued under the aegis of the US fiscal stimulus package which matches the duration of a typical ILS/catastrophe bond issuance and is, accordingly, self-liquidating has also greatly facilitated the improvements to the collateral packages of transactions which have retained a swap counterparty.

Considered by themselves, these changes should not result in any change to the UK taxation treatment of insurance linked securities set out in Chapter 24.

C. **Use of collateral that matches the payment flows on the catastrophe bonds**

An alternative structure used on the Blue Fin Ltd. Series 2, Calabash Re III Ltd. and Vita Capital IV Ltd. transactions in 2009 was to have collateral, the cash-flows on which matched the cash-flows on the catastrophe bonds, avoiding a mismatch and the resulting need for a TRS.

In these transactions, a "AAA" rated government-guaranteed entity or supranational institution issued debt securities designed specifically to collateralise the catastrophe bonds being issued. In the Blue Fin Ltd. Series 2 transaction, the collateral was a floating rate note with a 3.75 year final maturity issued by the German *Kreditanstalt für Wiederanfbau*, a "AAA" rated highly stable German financial institution, whose obligations are guaranteed by the German government.

A similar strategy, which also helps to mitigate the problem of a maturity mismatch, has been to invest the proceeds of the issuance of catastrophe bonds in money market funds. The liquidity of the money market funds minimises the market value risk which may occur when it becomes necessary to liquidate the collateral and this structure may therefore be slightly more flexible (for example, in the event of early redemption or extension to maturity of the catastrophe bonds) than specifically designed collateral.

In a UK taxation context, these collateral arrangements should not result in a changed taxation analysis when compared to a catastrophe bond transaction using a TRS collateral structure, with all of the taxation aspects regarding the location of the SPV issuer's assets continuing to be potentially relevant (see paragraph 24.2.3).

D. **Use of a sale and repurchase arrangement**

1. A third method of arranging a security package to collateralise a catastrophe bond which was seen in market transactions in 2009 was to replace the TRS with a sale and repurchase agreement with a counterparty (the 'repo counterparty') generally also the arranger of the catastrophe bond transaction.

2. This security structure was used on the Eurus II Ltd. and Atlas VI Capital Ltd. transactions in 2009. The following section briefly considers some of the mechanics used in these transactions and the relevant UK taxation issues which arise in consequence of these mechanics.

3. The primary purpose of the repurchase agreement is to provide a means of investing the proceeds of the issue of the catastrophe bond notes (the "**Notes**") to generate a EURIBOR linked return which will be collateralised by securities which: (i) meet certain eligibility conditions; and (ii) can, through their sale and repurchase under a GMRA, generate an ascertainable value which will be used to repay the principal amounts owed by the SPV issuer on the Notes or meet certain obligations under the counterparty contract.

4. Under the GMRA, the proceeds of the catastrophe bond issuance are used to purchase, from the repo counterparty, book entry interests in a pool of non-convertible, rated corporate or sovereign debt securities that are not "net paying securities" as defined in the GMRA. These securities are held by the SPV issuer in a collateral account and are the subject of security in favour of the indenture trustee.

5. The securities purchased by the SPV issuer under the repurchase transaction are in book entry form, i.e. immobilised in a clearing system, with the legal interests in the assets being held by a nominee for the clearing system. The structural mechanics of the repo arrangements are intended to minimise performance risk, and this may take the form of the aggregate amount of the securities held by the SPV issuer being adjusted through daily margining conducted by a third party (the 'triparty agent') on each business day during the duration of the repo. The principal protection thereby avoids the pitfalls of the pre-crisis Lehman sponsored catastrophe risk deals (referred to above) where the securities or other assets held in the collateral amount lost significant value.

6 A separate sale and repurchase agreement is drafted for each series of catastrophe bonds issued, usually under a GMRA. Under each GMRA the SPV issuer, as repo buyer, will enter into a series of repurchase transactions with the repo counterparty, as repo seller. Under each of the repurchase transactions:

(i) the repo counterparty sells the interests in the eligible investments (the "**repurchase securities**") to the SPV issuer for an arm's length amount (the "**repurchase payment**"), and

(ii) the repo counterparty agrees to, on the applicable date for completion of the repurchase transactions, repurchase the repurchase securities (or equivalent securities) from the SPV issuer for a price (the "**repurchase receipt**") comprising an amount equal to the repurchase payment in respect of the repo transaction and also an amount of EURIBOR return and extra spread.

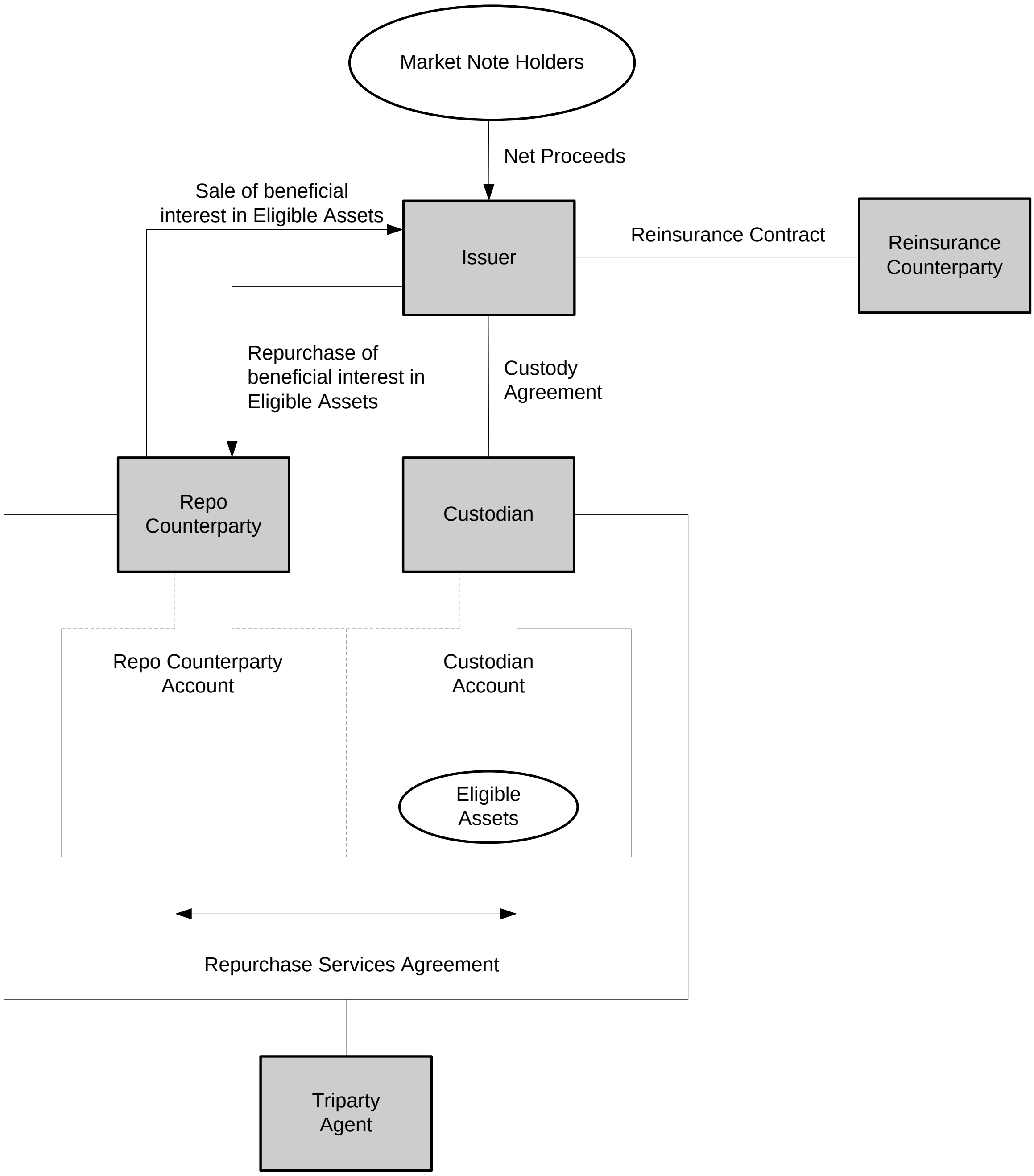
7 It is important that the custodian[6] through which the SPV issuer holds the interests in the repurchase securities does not have any discretion in respect of the securities held in the collateral account, does not habitually carry on the business of the SPV issuer in respect of the entire catastrophe bond transaction and is not responsible for monitoring whether such securities are eligible or whether the aggregate value of the repurchase securities is at least equal to the repurchase receipt to be paid by the repo counterparty to the SPV issuer. The selection of the securities which will be used for sale and repurchase under the repurchase agreement is made by the triparty agent from the eligible investments standing to the credit of the repo counterparty's account with the triparty agent and using an automated methodology arranged between the parties.

8 The triparty agent monitors, on an ongoing basis, the value of the repurchase securities and their compliance with the eligibility criteria and makes substitutions to reflect any non-compliance with the eligibility criteria. The triparty agent will also transfer securities between the repo counterparty's account and the SPV issuer's custodian account to ensure that the value of the repurchase securities, taking account of required overcollateralization, is maintained.

9 The SPV issuer's source of funds for repayment of the outstanding principal on the Notes is the repurchase receipt received on the re-sale of the repurchase securities at the completion of the repurchase transaction.

[6] In a European context, custodian arrangements avoid the need for the SPV to hold an account directly with a clearing system (such as Euroclear or Clearstream). The SPV appoints a custodian who is an existing account holder with the clearing system and the sale and repurchase of book entry interests takes place at the level of the custodian account holder. This was, for example, the case for the Eurus II Ltd. and Atlas VI Capital Ltd. transactions in 2009.

Paradigm European Repurchase Collateral Arrangement



10 *The SPV issuer, acting as repo buyer*

10.1 As noted at Chapter 24 of the Handbook, the SPV issuer should be incorporated and centrally managed and controlled outside the UK, and therefore not resident for UK tax purposes. The main areas of focus from a taxation perspective will therefore relate to the potential imposition of withholding taxes, stamp taxation and VAT.

10.2 For withholding tax purposes, the UK tax rules deem a manufactured interest payment to be made to the repo buyer (here the repo counterparty), irrespective of whether one is actually paid or not, on the date when any underlying income is paid to the repo buyer (here the SPV issuer) on the repurchased securities.[7] Under the terms of the standard form GMRA, where the term of the repurchase agreement extends over an income payment date in respect of any securities which are subject to the repurchase transaction, the repo buyer (here the SPV issuer) is required to transfer and amount equal to the payments actually made on the securities.[8] Such amounts, known as "manufactured payments", are required in the standard form GMRA to be paid "without any withholding or deduction for or on account of taxes or duties notwithstanding that a payment of such income in such circumstances may be subject to such withholding or deduction".[9]

10.3 Regardless of whether an actual payment of underlying income is made on the repurchase securities which are the subject of the repurchase agreements over the term of the repo, amounts which are "representative" of the income payable under such securities will be deemed to be paid by the SPV issuer owing to the provisions of section 925B Income Tax Act 2007 ("**ITA**"). The provisions of section 925B(2) ITA deem a repo buyer under a "debtor repo" (here, the SPV issuer) to have paid to the repo seller (here, the repo counterparty) amounts which are representative of the income payable on the repurchase securities.[10]

10.4 There should be no withholding obligation on the SPV issuer on the deemed manufactured interest where the SPV issuer (which is making a payment of manufactured interest under the GMRA terms) is not resident in the UK and is not carrying on a trade in the UK through a UK permanent establishment. Given that the SPV issuer will not typically be resident in the UK in a catastrophe bond transaction, it should therefore not be liable to deduct UK withholding tax on either any actual manufactured payments made by it under the GMRA terms or any deemed manufactured interest payments which the SPV issuer is deemed to make under the UK tax legislation.

11 *The repo counterparty*

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7 Section 578(2) and 925B ITA.

8 Standard form GMRA published by The Bond Market Association and the International Securities Market Association, version October 2000, clause 5(a).

9 Standard form GMRA (clause 5).

10 The UK tax rules also have the effect that the repo seller (here the repurchase counterparty) is further deemed section 925B(2) ITA to have received those manufactured payments on the repurchase securities.

11.1 The UK tax position of the repo counterparty, is simplified in the event that it not resident in the UK and it does not enter to the repurchase agreement through a UK permanent establishment. In this situation, any deemed manufactured payment treated as being made to the repo counterparty outside the UK should not be subject to UK withholding tax.[11] However, in a number of situations, it may not be possible to contract with a repo counterparty that is a non-UK entity or through a non-UK branch. In these situations, the UK taxation treatment of the repo counterparty, becomes highly material to the transaction.

11.2 Very broadly, the UK corporate tax legislation relating to repurchase agreements provide for the tax treatment of a repo to follow its accounting treatment under GAAP or IFRS. The repo counterparty should only be liable to pay UK corporation tax in relation to the repurchase transactions insofar as credits and debits relating to those transactions are brought into account in determining the profits attributable to the UK resident repo counterparty (or to a permanent establishment of the repo counterparty in the UK).

11.3 For UK corporation tax purposes, an arrangement which involves the repo counterparty effecting the sale and repurchase of the eligible assets used in the repurchase transaction and which equates in substance to a lending of money at interest from the SPV issuer to the repo counterparty should be taxed as a lending of money at interest to the repo counterparty under section 542(1) of Corporation Tax Act 2009 ("**CTA**").

11.4 For the purposes of section 550 CTA, the repo counterparty should be treated as continuing to hold the assets used in the repurchase transaction "for any period for which the arrangement is in force".[12] An arrangement is in force from the time the securities are originally sold to the time when the relevant repurchase takes place, or it becomes apparent that the repurchase will not take place.[13] The effect of paragraph section 550(3)(a) CTA should therefore be that the sale and repurchase of the repurchase securities is not ignored[14] but rather that there are two "related transactions",[15] being a disposal of the assets and a re-acquisition of the repurchased securities, with both disposal and reacquisition occurring on the repurchase date[16]. Where the securities actually repurchased by the repo counterparty are the same assets as those originally sold under the repurchase agreement, a charge to corporation tax should only arise where IFRS prescribes that income is recognised in determining the repo counterparty's profits and losses on the "related transaction" for the accounting period in which the repurchase transaction takes place. An amount is recognised in determining profits and losses if it is recognised in the repo counterparty's profit and

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11 The absence of UK withholding tax being charged on the repurchase counterparty in this situation is also a result of a non-UK resident repurchase counterparty being outside the scope of UK tax under the "reverse charge" set out in section 920 ITA 2007 (see further below).

12 Section 550(3)(a).

13 Section 552(2) CTA.

14 Cf. paragraph 6, Schedule 13, FA 2007 which explicitly ignores both transfers for the purposes of chargeable gains (which are not applicable here as the transfers would otherwise fall within the loan relationship rules).

15 Section 304 CTA.

16 Section 550(3)(a) CTA, although the statutory mechanics under which the two related transactions are recognised on the termination of the sale and repurchase agreement could, it is respectfully submitted, have been made clearer by the Parliamentary Draftsperson.

loss account, income statement, statement of recognised gains and losses, statements of changes in equity or other statement of items brought into account in calculating the repo counterparty's profit and loss account for the accounting period in which the transaction is effected.[17] On the repurchase date, there should therefore be a debit of the fair value (less impairment) of the assets and a corresponding credit of the fair value (less impairments) of the same assets (assuming no equivalent assets are purchased under the repo) for corporation tax purposes. While the position would need to be confirmed by accounting advisers, it would appear to be reasonable to assume that on the repurchase date such corresponding debit and credit will usually match.

11.5 Where the repurchase agreement is settled with "equivalent assets" (as permitted under the GMRA standard form), the taxation mechanics should not change from the analysis set out above where the repo assets are simply repurchased. The repurchase of equivalent assets by the repo counterparty should be treated as a "related transaction" under the loan relationships legislation. A corporation tax charge (or relief) would only arise where IFRS accounting treatment of the transaction for the repo counterparty prescribes that income is recognised in determining the repo counterparty's profits and losses on the related transaction for the accounting period in which the repurchase transaction takes place.

11.6 The consequences of the legislative approach set out above are, broadly, that the repo counterparty should be taxed in accordance with the "real" financing cost of the repurchase transaction (being the finance charge for the repo). Under section 551 CTA, the finance charge should be deductible for the repo counterparty's corporation tax purposes but only to the extent of the amount that is recognised in accordance with accounting practice as a finance charge in respect of an advance in the accounts of the repo counterparty in respect of the repurchase transaction.[18]

11.7 In accordance with this general approach, there is also no requirement for the repo counterparty to be taxed on manufactured payments (although the income tax withholding rules add certain complications to the corporation tax analysis).

11.8 Owing to, very broadly, any finance charge (if any) paid by the repo counterparty to the SPV issuer in respect of the repurchase transaction being treated as interest under the UK tax legislation relating to repos,[19] it is necessary to consider whether any withholding tax would arise on the payment of that finance charge.

11.9 Where the repo counterparty is a "bank" (as defined in section 991 ITA 2007) and pays the finance charge in the ordinary course of its banking business, no withholding should arise on payment of such a finance charge. A number of conditions are present within this exemption, most importantly that the entry by the repo counterparty into

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17 Sections 308, 309 and 558 CTA.

18 Section 551(4) CTA. In determining whether the finance charge is tax deductible for UK corporation tax purposes, it is important to determine that the repurchase counterparty (i) prepares its *solus* accounts under IFRS; (ii) recognises the repurchase transactions as liabilities for the purposes of its *solus* accounts (thereby standing as a debtor as respects the repurchase transaction for the purposes of IFRS); (iii) retains the risk of price fluctuation in respect of the repurchased assets which are the subject of the repurchase transactions; and (iv) shall continue to recognise as income any interest accrued in respect of the assets which are the subject of the repurchase transactions.

19 Section 551(4) CTA.

the transactions pursuant to the GMRA will: (a) not be regarded by the repo counterparty as conforming to any of the definitions of Tier 1, Tier 2 or Tier 3 capital adopted by the Bank of England (regardless of whether such transactions actually count towards tier 1, tier 2 or tier 3 capital for UK regulatory purposes); and (b) not be regarded as primarily attributable to an intention to avoid UK tax by the repo counterparty.[20]

11.10 One final point requiring consideration regarding the withholding aspects of the repurchase transactions is whether the repo counterparty could be construed as subject to UK withholding tax on payments of deemed manufactured payments through what is referred to in the relevant UK legislation as the "reverse charge". Where the repo counterparty is a UK seller of the repurchase securities (or is a non-resident company carrying on a trade in the UK through a UK branch or agency), it will be liable to account for the tax for which the repo buyer (here the SPV issuer) would have been liable to account if the repo buyer had been resident in the UK and subject to withholding obligations under section 919 of ITA 2007. This is known as the "reverse charge".[21] In any catastrophe bond structure, such a "reverse charge" would be highly adverse to the commercial interests of the respective parties to the transaction.

11.11 Section 921(1)(b) ITA 2007 provides that the "reverse charge" provisions of section 920 ITA 2007 shall not apply where the manufactured interest is representative of interest on either gilt-edged securities or securities which are not gilts but on which the interest is payable without deduction of income tax. Where gilt edged securities are not suitable for inclusion in the assets which are the subject of the repurchase agreements, it may be possible to avoid the risk of a "reverse charge" on a UK resident repo seller (or UK permanent establishment) by ensuring that the repoed assets are securities which are not subject to withholding on interest payments. In this context, a number of amendments to the standard form GMRA documentation may be necessary. These include:

(a) including in the annex of supplemental terms and conditions to the GMRA that no transactions in "net paying securities" will be made under the repurchase agreement, thereby ensuring that any securities which might be paid subject to a domestic tax withholding (were a payment to be made directly to the repo seller) in the jurisdiction in which the interest on the securities arises are ineligible for inclusion in the repo[22]; and

(b) replacing the standard form wording in clause 5 of the GMRA with drafting which removes the obligation on the SPV issuer to "gross-up" any payments of manufactured interest to be made by the SPV issuer (as repo buyer) to the repo counterparty (as repo seller) under the repurchase agreements.

20 For the purposes of the exemption at section 878 ITA. See also HMRC Statement of Practice 4/96.

21 See paragraph 3(5), Schedule 23A, ICTA 1988 for periods before 2007-08 and section 920, ITA 2007 thereafter.

22 The definition of "net paying securities" is included in the GMRA: being "Securities which are of a kind such that, were they to be the subject of a Transaction to which paragraph 5 applies, any payment made by Buyer under paragraph 5 would be one in respect of which either Buyer would or might be required to make a withholding or deduction for or on account of taxes or duties or Seller might be required to make or account for a payment for or on account of taxes or duties (in each case other than tax on overall net income) by reference to such payment".

On such changes being effected, the position should be achieved that the deemed manufactured payments treated as being made pursuant to sections 925A and 925B ITA should not be subject to any withholding on account of UK income tax. Accordingly, such securities should fall within the class of securities identified in section 921 ITA 2007, resulting in the absence of a “reverse charge” being imposed on a UK repo seller.

11.12 It may also be possible to ensure that deemed manufactured payments are not subject to UK withholding tax through selecting repurchase debt securities which fall within the definition of in respect of “overseas securities” within section 559 CTA, being any securities issued by non-UK corporate or sovereign issuers. This exemption arises from the complex rules for manufactured overseas distributions, although in practice limiting the class of potential repurchase securities to exclude securities issued by UK corporates and gilt-edged securities may be impracticable (regulation 2B, SI 1993/2004).

12 Value Added Tax

Whether the repo is seen as a lending of money or a transfer and retransfer of securities, the supplies which arise as a result of the repurchase transaction should be exempt from VAT as they should fall under Item 2 (in respect of the making of any advance or the granting of any credit) or Item 6 (in respect of the transfer of or dealing with any security such as debentures) of Group 5 (Finance) of Schedule 9 of the Value Added Tax Act 1994 and therefore be exempt for UK VAT purposes.

13 UK Stamp Duty and Stamp Duty Reserve Tax (“SDRT”)

13.1 If the repurchase securities held by the repo counterparty are immobilised in a clearing system, it should be possible to effect the repurchase arrangements in respect of the book entry interests in those securities rather than effecting a transfer of the legal and beneficial interests in the securities themselves. The appointment of a triparty agent assists in the facilitation of this arrangement, enabling the triparty agent acting under a servicing agreement to utilise a daily automated selection mechanism to determine the repurchase securities held by the repo counterparty in the clearing system which are to be used for the repurchase transaction. Generally, the servicing agreement will contain extensive provisions regarding the terms under which the triparty agent acts, including details of the operational mechanics governing the automated selection system. The provisions of the servicing agreement may also be supplemented in this regard with references to the mechanism of transfer of the repurchase securities being by way of transfer through book entry interests.

13.2 Following the identification of the repurchase securities by the triparty agent, the book entry interests in the repurchase securities can be transferred from the repo counterparty to the SPV issuer pursuant to the repurchase transaction.

13.3 Under section 125(1) FA 2003, UK stamp duty is stated to be chargeable under Schedule 13 of FA 1999 only on written instruments transferring stock and marketable securities. The mechanism by which electronic transfers of book entry interests will be effected should not, broadly speaking, give rise to a stampable transaction. Similarly, no SDRT should be chargeable on the transfer of the book entry interests in the repurchase securities pursuant to the repurchase transactions. Although the imposition of SDRT is not dependent on the creation of a written instrument of transfer being executed, the general charge for the imposition of SDRT under section 86 FA 1986 is inapplicable as regards an agreement to transfer "chargeable securities" where "the Board are satisfied" that the securities in question are held within a clearance service at the date the agreement effecting such a transfer is made.[23] This provision does not require the Board of HMRC to adjudicate the repurchase agreement. It is considered that a court would be able to conclude on the applicable facts that the necessary conditions have been met, were such a conclusion required.[24]

13.4 The specific charging section for clearance services is only applicable where chargeable securities are transferred to a person operating a clearance service,[25] which would not be the case where the repurchase securities were already immobilised within the clearance service.

13.5 However, in the event that a triparty agent is not used in the transaction, two other sets of exemptions may also be available. The first set provides exemptions from stamp duty and SDRT on the repurchase arrangements. No stamp duty or SDRT should arise on the sale and repurchase of the repurchase securities if the following conditions are satisfied:

(a) the repo counterparty is authorised under the laws of an EEA State to provide investment services comprising either the execution of orders on behalf of clients or dealing on own account, in either case and within the meaning of Paragraphs 2 & 3, Section A, Annex I of Directive 2004/39/EC of the European Parliament and of the Council (the "**Directive**");

(b) the repurchase securities acquired by the SPV issuer under the repurchase agreement are of a kind that is regularly traded on a regulated market, within the meaning of Article 4(1)(14) of the Directive;

(c) the repurchase agreement has been made on arm's length terms; and

(d) no risk or benefit arising from the fluctuation in the market value of the repurchase securities acquired under the repurchase agreement accrues to or falls on the SPV issuer.

The second exemption provides a complete exemption from stamp duty and SDRT in respect of, very broadly, loan capital (being defined as including any debenture stock, funded debtor capital raised by a company or other body or persons which has the character of borrowed money: section 78(7) FA 1986) provided that the loan capital in question does not carry any right:

(i) to conversion into shares or other securities, or to the acquisition of shares or other securities;

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23 Section 90(5) FA 1986

24 *Leigh Spinner v IRC* [1956] 46TC 425 at 433-434; *Central and District Properties Limited v IRC* [1966] 1 WLR 1015 at 1024.

25 Section 96(1)(b) FA 1986

(ii) to an amount of interest which exceeds a reasonable commercial return on the nominal amount of capital of the security;

(iii) to an amount of interest which falls, or has fallen, to be determined to any extent by reference to the results of, or of any part of, a business or the value of any property; or

(iv) on repayment to an amount which exceeds the nominal amount of the capital of the security and which is not reasonably comparable with what is generally repayable (in respect of a similar nominal amount of capital) under the terms of issue of loan capital listed on the Official List of the London Stock Exchange.

14 Other Participants

14.1 Finally, it is necessary to consider briefly the remaining participants in the security structure using a repurchase transaction.

14.2 **Custodian**: Where a UK resident custodian (or non-resident custodian acting through a UK permanent establishment) is appointed as agent for the SPV issuer in respect of the repurchase transaction, care will need to be taken to ensure that it cannot be construed as serving as a UK permanent establishment of the non-UK resident SPV issuer. The role of the custodian as agent for the SPV issuer in respect of the repurchase transaction should be limited in scope, and the role of the custodian should preclude it from having authority to conclude contracts in the SPV issuer's name or conduct business on behalf of the SPV issuer generally. Additionally, the custodian should have no discretion regarding entering the repo, selecting repo securities and no responsibility for monitoring whether the repurchased assets are either eligible to be used under the repo or whether they are of a sufficient value to achieve the desired proceeds when re-sold. Accordingly, the custodian arrangement should not result in the custodian habitually exercising authority to do business on behalf of the SPV issuer in the UK. Furthermore, the custodian should not be considered to be providing "investment management services" through its actions as agent for the SPV issuer in facilitating the entry into the sale and repurchase transaction through a clearing system. It's actions as agent are likely to be merely preparatory and auxiliary under the terms of the Custody Agreement under which it operates.

14.3 **Indenture Trustee**: The UK tax position of the indenture trustee should not be adversely affected by the use of a repurchase agreement relating to the collateralisation of the Notes.

14.4 **Triparty agent**: The use of a triparty agent, materially assists the repurchase mechanisms effected using European clearing systems such as Euroclear Bank N.V. whereas this role [would be undertaken by the custodian account holder where the Depository Trust Company is the relevant clearing system].

[5154 words]