HSBC

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Dear Sir

Re: Comments on Discussion Draft – Clarification of the Meaning of "Beneficial Ownership" in the OECD Model Tax Convention

HSBC welcomes the opportunity to comment on the OECD's consultation on the meaning of the tem Beneficial Ownership in the OECD's model tax convention.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,455 billion at 31 December 2010. Headquartered in London, HSBC serves customers worldwide from more than 8,000 offices in 87 countries and territories in six geographical regions. HSBC's businesses encompass a very broad range of financial services and products, including personal financial services, commercial lending, global banking and markets, private banking, asset management and insurance.

HSBC supports the OECD's aim of giving more clarity, certainty and consistency to the term "beneficial ownership" by updating the OECD Guidance for this term. Unfortunately, we feel that the current version of the draft guidance may increase uncertainty around the interpretation of the term "beneficial ownership", and could lead to increased risk that treaty benefits could be incorrectly denied due to inconsistent interpretation. In particular, there is a risk that the draft guidance may be misinterpreted with respect to derivatives, resulting in the term being applied inconsistently and inappropriately in a way we do not believe is intended. This has the potential to have significant impacts on worldwide securities markets. Financial institutions that experience certainty as to their withholding tax liability may be discouraged from providing impacted products to clients, reducing availability of hedging and market access products, and ultimately affecting market volumes and liquidity.

We are aware that there is inconsistency in the way the beneficial ownership concept is applied worldwide, and, whilst we understand that the changes to the guidance seek to address this, we are concerned that the amended guidance may potentially amplify this

problem rather than correct it. There have been a number of recent examples where tax authorities have attempted to deny treaty relief (we believe erroneously) by contending that a party is not the "beneficial owner" of income from a security where there is a derivative in place to hedge that party's exposure to that security. It would be helpful if the OECD guidance addresses this issue and makes it clear that derivatives, as a general rule, do not impact the beneficial ownership of income from referenced assets/securities for Tax Convention purposes.

Our reasons for this are set our below:

- The way para 12.4 (and 10.2, 4.3) is currently drafted can be read as applying more widely than just to agent, nominee or conduit relationships. We recommend that the paragraphs be amended so it is clear that they only apply to those types of relationships.

- We are concerned that the wording of para 12.4 (and 10.2, 4.3), which deals with determining whether the recipient of income has the full right to use and enjoy income, may introduce increased uncertainty and an element of subjectivity. Given this, we suggest that the wording of the paragraph be updated to clarify further what is intended. Our view is that an income recipient has full right to use and enjoy income unless another party has real and actual control (legal or contractual) over how that particular item of income is used. In particular, we suggest inclusion of wording to the affect that equivalent payments under derivatives will not generally mean the payer does not have full use and enjoyment of any income earned on any underlying hedges.

- There seems to be a significant focus in para 12.5 on the "beneficial ownership" term being used as an anti-avoidance tool. Previous guidance has stated that the term should be viewed in light of the object of a Tax Convention to "avoid double taxation and the prevention of fiscal evasion and avoidance". The revised guidance places increased emphasis on anti-avoidance as opposed to avoiding double taxation. We are concerned that this could lead to the term being used subjectively and opportunistically to deny treaty relief. We do not believe this is the intention of the redraft.

Derivatives - further discussion and examples

- Businesses in all areas of the economy (whether Financial Services, Commerce and Industry or other) use derivatives to manage exposure to various risks. Entering into derivative agreements allows the creation of synthetic exposure to offset and neutralise the economic risks of holding assets or liabilities, or to give parties desired exposure without the need and cost of acquiring underlying assets.

- Examples:

    - Use of derivative to hedge exposure to a corporate or government bond:

      A company may have surplus cash which it chooses to invest in corporate or government bonds. At some point the company may decide to reduce some of its risk of loss from holding those securities. The company could do this by entering into a total return swap (TRS) through which it gets a synthetic short

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exposure to the bond. Under the terms of the swap, the swap counterparty will pay the company an amount for any fall in market value of the bond. In return, the company will make payment to the TRS counterparty for any increase in value of the bond and any interest received on the bond. This neutralises the company's economic exposure to the bond but the company retains all the rights and obligations of a bond holder/owner, including the right to receive interest/coupons and to use that income unconstrained by any other party. The TRS counterparty has no control (legal or otherwise) over how the company uses the income from the bond. In fact, the company may chose to sell the bond, lend it, or post it as collateral under some other unrelated obligation. If the company was to do this, it would not receive any interest income paid from the bond issuer, however it would still have the obligation to pay an interest equivalent payment under the TRS.

It is an important point that the derivative is in no way linked to the ownership of the bond (or income from the bond) by the company. The obligations under the derivative must be satisfied regardless of ownership.

- Equity swaps or market access products:
  Companies and other investors require exposure to a wide range of equities. Often they will choose to get such exposure "synthetically", as opposed to "real" exposure from acquiring the share itself. The reasons for this are many, and include the following:

  - Investors are unable to invest directly in shares of various countries for regulatory reasons;
  - Investors may not have the operational capabilities to buy and sell shares of certain countries, or it simply may be uneconomical to do so.
  - Derivatives can provide efficient, quick and easy way to gain long or short exposure and to hedge risk.
  - Derivatives can provide leverage, giving investors access to cheaper / superior finance. There is no asset purchase or loan. The investor obtains exposure to assets equivalent to investment financed by debt
  - Derivatives can provide exposure where availability/liquidity of the underlying assets is limited/restricted.
  - Derivatives typically provide for lower transaction costs / operational costs. There can be one contract rather than numerous settlements, and investors can save in terms of not having to deal with custody fees, records, corporate actions etc.
  - Derivatives under ISDA contracts[1] help mitigate counterparty credit risks: All transactions under ISDA can be netted
  - The treatment of derivatives may have different regulatory/capital treatments to holding the actual underlying assets.
  - In some markets, synthetic positions are not subject to local stamp/transaction duties.

[1] International Swaps and Derivatives Association Master Agreement

To satisfy such demand, a financial institution (FI) may offer clients synthetic exposure to referenced equities using an equity swap or market access product.

For example, the FI and client may enter into a total return swap which references a share, whereby the FI pays the client the equivalent of the amount of any increase in value of the referenced share and the equivalent of the amount of any dividends paid on the referenced share. The client is required to pay the FI the equivalent of the amount of any decrease in value of the referenced share in addition to a fee for the supply of the product. The FI has exposure to the performance of the referenced share and exposure to the risk of the client defaulting on its obligations under the swap (counterparty risk). In order to hedge its exposure to the performance of the referenced equity, the FI may purchase the share or enter into another derivative (although it has no legal or contractual obligation to do). By entering into the swap the client has economic exposure to the referenced share; however it does not enjoy any rights of ownership of the share or rights to the income stream from the share. For instance, the client does not enjoy the rights of a shareholder such as the ability to vote. The client has no legal relationship with the company issuing the share. Conversely, the FI solely holds all the rights under the share including the right to use any dividends as it choses. The FI is also free to do with the share what it pleases, including selling the share, lending it to another party or using as collateral for other obligations it may have.

It is an important point to note that the client in no way (legal or otherwise) has any control over whether the FI holds the share, whether it receives dividends on the share, or how it uses any dividends that it receives.

This fact was recently illustrated in the Lehman Brothers collapse, where Lehman clients with swap/market access products had claims under those derivative contracts only. The clients had no direct claim at all over the shares (or dividends from those shares) that Lehman may have held as hedges to its exposure.

Why we believe derivatives should not be viewed as transferring beneficial ownership of income from a security

Derivatives should not be considered to transfer beneficial ownership of income from referenced securities (such as dividends on shares or interest on bonds) for the following reasons:

- For a derivative to transfer beneficial ownership of dividends/interest, this implies that one of the parties is actually receiving dividends/interest in the first place. This is by no means always the case as there is no requirement for a party paying amounts referenced to dividends/interest to acquire the underlying securities or to ensure that it receives the real dividend/interest payments to which the derivative is referenced.

  The obligations under the derivative are entirely independent of whether a party holds the reference securities and receives the referenced income.

- A derivative does not typically transfer legal ownership of any asset (although some derivatives may be physically settled on termination).

- A derivative does not typically give any party any rights over a real asset or income flow (although some derivatives may be physically settled on termination).

- A derivative in itself does not give either party "control" over the other, or enable either party to restrict in any way how the other uses and enjoys its assets and income.

- A party to a derivative will have a right to receive payments referenced to amounts of dividends on a share or interest on a bond, however it has no direct exposure or rights to the dividend or interest itself.

- Entering into a derivative contract is a vital business tool for managing risk and/or gaining synthetic exposure.

- A derivative contract creates real counterparty risk. As with any contract between parties, under a derivative there is a real risk that obligations are not met by one or either of the parties. This risk exists regardless of what happens to the underlying referenced security and whether it is held or not.

  This is an important point as it shows that a derivative does not create a conduit relationship. In a conduit relationship, one party typically has control over the other or has recourse to the assets and income of that party. In reality there is generally little risk of one party defaulting on the other. This is not the case with a derivative between two independent parties.

Given the above, we believe it is important that the new guidance is drafted in a such a way as to avoid the potential interpretation that derivatives transfer beneficial ownership of a referenced flow of income as a general rule. In order for hedging to be effective, and for parties to be able to price derivatives accurately, we think it would be helpful to clarify that beneficial ownership is not generally impacted by parties entering into a derivative.

In practise, if a hedging relationship via a derivative was deemed to transfer beneficial ownership from a party receiving the income, then this may lead to double taxation. This is because, under most treaties, the dividend and interest articles are drafted such that parties must receive the income ***and*** be the beneficial owner of the income in order to claim relief. If the income recipient and the beneficial owner are two different parties, then the ability to claim treaty relief would appear to be lost. This seems contrary to the stated purpose of the treaties.

We feel that if tax authorities are dissatisfied with the treaty implications of transactions, they have the ability to change their domestic law to address their concerns. The recently enacted HIRE Act in the USA can be viewed as an example of this whereby US tax law now provides that certain defined total return swap dividend equivalent payments made to non-US counterparties can be subject to US withholding tax.

We trust you find the above comments helpful.

Yours faithfully

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