The Tax Landscape

A Custodian's Perspective

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The securities taxation industry is at an inflection point: the rapidly transforming tax regulatory environment requires a heightened focus on data, technology and tax risk management strategies. Global custodians, now more than ever, must strengthen their positive and productive partnerships with tax authorities and clients alike to ensure the continued delivery of an optimal tax service offering. This whitepaper is intended to provide a macro overview of the current environment, including a review of key themes and challenges, along with resultant areas of focus in combination with a lens toward future trajectory.

The Tax Challenges

Over recent years, as global fiscal authorities have introduced further measures to combat tax abuse, the world of custodial taxes has grown in complexity. On the one hand, institutional investors, striving to outperform the markets, continue to diversify their investments, resulting in an increased demand for custody tax services across new source jurisdictions and therefore a consideration of new "rule" sets. In parallel, there has been an ongoing uptick in the pace, volume and complexity of tax market change: Custodians are no longer solely concerned with withholding tax ("WHT") but are faced with administering a range of tax types (e.g. FTT, CGT[1]); new anti abuse mechanisms have required an agile response (e.g. holding periods); and the Industry has been faced with a wave of new "Tax Regulation" (e.g. DAC6; CRS[2]). In a nutshell, global custodians and clients alike are experiencing heavier tax compliance obligations as a result.

[1] "FTT" – Financial Transaction Tax / "CGT" – Capital Gains Tax

[2] "DAC6" – The EU's 6th Directive n Administrative Cooperation concerned with the Mandatory Disclosure of cross-border tax arrangements; "CRS" – Common Reporting Standard implemented by the OECD.

Criticality of Custodians providing good tax data

Through increased regulatory requirements, tax authorities are also calling on financial services intermediaries to support their policing of adversarial tax behaviours more and more. As the guardians of substantial data lakes, custodians are increasingly required to deliver client tax data and provide data analytics which in and of itself is wide ranging. Reliable data should always be the beating heart of a sound tax compliance operating model, and inaccurate data, in the context of tax relief management, can lead to a material impact. It is no longer simply enough to pay the right amount of tax – tax authorities are demanding detailed information on beneficial owners with the expectation that it will, in part, be delivered by the custodial community as the holder of the Custody Book of Record. Therefore, having robust client tax data and an efficient and seamless mode to extract and deliver that data to our clients and tax authorities alike has become paramount. The tax data and reporting strategy is more important than ever.

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Technology's Impact on Tax Authorities

The tax environment as described has in part been facilitated by technological advances that have provided benefits but also challenges. In particular, these developments have enabled technology transformation on the side of the tax authorities who now have the tools to more deeply interrogate and scrutinise the data at their hands. Being able to more readily consume and digest information that can be easily absorbed into databases has provided a quicker and easier path to investigations with the intention of identifying tax compliance breaches and/or underpayment of taxes due. As the tax authorities adopt newer tools and technology, the old world of tax compliance is evolving – there is momentum for processes to go paperless, and Governments are increasingly at the forefront of the technology transformation. Tax Authorities are further becoming informed by a continued drive to the "Automatic Exchange Of Information" and the sharing of that data with each other.

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Technology Advances

Deploying technology to support the management of tax compliance is not confined to the Regulators alone. Custodians have been on an equivalent path – ensuring the investor appetite for real-time accurate data and technology expectations of the moderators of our world are met. The purpose should be viewed as twofold - to enhance the client support model in an area that can be prone to uncertainty (with heavy documentation demands, to boot) and to assist in ensuring compliance with the ever-expanding tax rule set referred to above. Taking each of these in turn, let us first focus on the "**internal**" technology effect for the custodian.

The critical question to answer is — where does one get the biggest (technology) yield associated with the delivery of the tax product offering to further streamline and optimise the end-to-end tax operational processes? Various options should and have been considered in this context. For example, it is well recognised that the compilation and lodgement of withholding tax reclaims is at the more administratively burdensome end of custody tax processing. The ideal scenario therefore is to be able to systemically compile submission packs regardless of the lack of market harmonisation (currently) at play. That is directionally where Custodians are headed. Sticking with the tax reclaim theme – in the last few years, a common challenge for Custodians has been the need to respond to the ever increasing trend of reclaim enquiry letters. Again, as tax authorities continue to home in on legitimate entitlement many and varied requests have come through requiring a wide range of voluminous transactional and holdings data. Therefore, devising efficient ways to manage such demands from an internal perspective should be the priority. Likewise, of equal importance should be devising new tax technology solutions in the tax documentation management space – the ability to digitally consume, review, record and store tax documentation within the walls of the servicer to enable secure, streamlined downstream processing must be the way forward. In all cases, devising how all of this and more is achieved is a key priority – consider Optical Character Recognition (OCR), Workflow, Application Programming Interface (API) and more – to continue to deliver an optimal tax technology strategy.

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Of equivalent importance to Custodians at the current time is also providing for full engagement from an **external** technology perspective. Fintechs, recognising the wave of technology deployment in the general regulatory space, continue to generate a substantial amount of activity within the Industry. For example, the use of Artificial Intelligence (AI) in the regulatory horizon scanning arena has been cogitated for some time, and in a small number of cases, deployment is underway. Whilst logical and admirable, it will take time (decades) to enable machine learning to a suitable degree in such a complex and fast-paced area. However, there are also a number of Fintechs promoting tax utility efforts – namely in a bid to create new tax ecosystems across the withholding tax space given the clear Business Case i.e. the process is fragmented, burdensome and paper-intensive. And whilst some Tax Authorities have been supportive and in a small number of instances where "Proof of Concepts" have proved successful, we are not there yet in terms of public formal endorsements. Hence, for now at least, such efforts are confined to investors and service providers only – when that changes, substantive transformation will occur. Key for now is ensuring as a Custodian we have a seat at the relevant tables to participate, learn, influence and benefit, where possible, from incremental industry "wins".

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The Risk effect

Of course, all of this must be considered against the backdrop of requiring a strong Tax Risk Management focus. It should be acknowledged that there is an incontrovertible need in the current tax domain compounded by a more hostile enforcement environment to build a resilient response to mitigate the external tax risk factors present. The response must demonstrate a clear articulation of the relevant tax risks accompanied by an efficient and practical plan to respond. In this regard, we recall the Organization for Economic Co-Operation and Development's (OECD) pronouncement of the concept of a "Tax Control Framework"[3]. The concept makes sense – housing in one place the tools, techniques and organisational arrangements to ensure all tax risks are identified, assessed and duly mitigated. The foundation of any custody product offering is of course the Regulation itself and the management thereof. Having a clear tax data strategy and a clear tax technology strategy and so on are also of pivotal importance now more than ever. The Custodian needs to be prepared to support the clients' position in this context.

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Will It Get Easier?

But is the tide turning? Is there hope for a more efficient tax world in the future? Perhaps.

First, consider current EU efforts to streamline existing WHT on income practices across the region – will this be a future neutraliser for the industry? It has long been recognised that a key barrier to efficient WHT relief processing derives from the lack of harmonisation of related tax legislation across the EU. As a region, not only do EU jurisdictions comprise the critical mass of a typical World Index, but they also represent where the most WHT activity is generally required. As a result, the current disparate rule set has been a common source of concern across the securities taxation industry. However, this has not gone unnoticed. There have been many efforts over the years to improve the situation. Recognising the status quo not only hinders cross-border investment but also increases the cost of cross-border trading, acts as

3 *The OECD's Report on Co-operative Tax Compliance: Building Better Tax Control Frameworks.* *https://www.oecd.org/publications/co-operative-tax-compliance-9789264253384-en.htm*

a barrier to achieving a single European market, provides for resource intensive procedures and ultimately results in investors foregoing their WHT relief rights. This position was arguably the genesis for the OECD's Tax Relief and Compliance Enhancement ("TRACE")[4] package, which sought to provide a standardised approach to WHT relief procedures. Subsequently, Finland was the first jurisdiction to go live in 2021 to implement a WHT regime following OECD TRACE – others suggested they would follow.

But perhaps more significantly has been the European Commission (EC) harmonisation efforts over the last few years.

Initially in 2017, the EC launched a Code of Conduct[5] on WHT seeking to address the current and recognised inefficiencies in the system. More recently in 2020, the EC set out proposals to deliver a streamlining of WHT processes as a part of the Capital Markets Union ("CMU") action plan called 2020 action 10[6]. Following the publication of a resultant impact assessment in 2021 and the release of a public consultation in April 2022, matters came to a crescendo last year. This month the EU Economic and Financial Affairs Council (ECOFIN) members reached a political agreement on FASTER. Whilst the ECOFIN is the sole legislator for the directive, the agreed text will be consulted with the European Parliament prior to its submission for formal adoption by the European Council and publication the EU's Official Journal. Member States are expected to have until 31 December 2028 to transpose the Directive in to their domestic legislation with the rules coming in to effect in 2030. So then is the WHT industry at an inflection point? Will the EC's recent proposals "stick", and if so how soon will we all feel the effects of a lighter WHT load as a result?

> Businesses are now expected to set out clear tax policies that align with their ESG policies

Now we look to the ever-popular topic of ESG and the intersection between ESG and Tax. Tax undoubtedly continues to rise further up the ESG agenda, hitting all of the "E" the "S" and the "G". Enabling a fully digital world in the future must be pivotal under the banner of "Environmental" considerations. The amount of tax paper currently circulating the globe could not be more directly contravenous of green principles. But arguably just as important is that the elements under the banner of ESG tax governance (the "G") and responsible tax behaviours (the "S") are increasingly being recognised as key elements of the ESG charter. From a "Social" perspective, businesses are now expected to set out clear tax policies that align with their broader ESG policies. A transparent tax strategy can act as a strong tool for companies to demonstrate their wider ESG contributions. Having a practice of tax integrity – a willingness to adhere to both law and society's unwritten rules as they relate to corporate tax is powerful. The "G" publicly demonstrating that a governance and risk management framework exists is intended to provide comfort and assurances that mechanisms are in place to drive awareness of pivotal tax principles and compliance. We then might hope that as the adoption of ESG in the tax space intensifies, the current attention on the side of the regulators will dissipate as they gain comfort in the accuracy of investor tax compliance.

4 https://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_Website.pdf

5 https://taxation-customs.ec.europa.eu/system/files/2017-12/code_of_conduct_on_witholding_tax.pdf

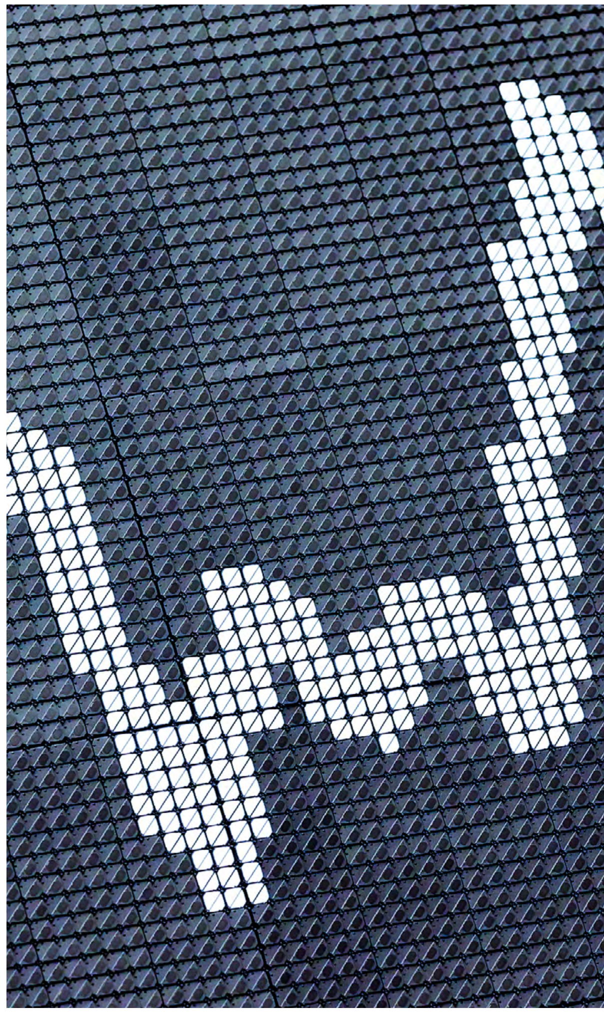
6 https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan/action-10-alleviating-tax-associated-burden-cross-border-investment_en

7 https://taxation-customs.ec.europa.eu/taxation-1/corporate-taxation/faster-initiative_en

The Tax professional

As a result of this evolution, the face of the tax professional has changed in recent years. Increased awareness of the environment described and the relevant skill sets are crucial for a modern tax professional to succeed. The challenges described present a real economic and reputational risk if mismanaged. Institutional investors must continue to recognise that poor WHT management may have a significant impact on fund performance. Therefore, there is a recognition that the new tax professional must not only demonstrate technical astuteness as ever – but must also be able to adapt with technology opportunities including data literacy and have an ability to convince and rally senior stakeholder support. Being able to provide a compelling case for the prioritisation of Tax and implement a robust tax strategy with the support of senior stakeholders is a prerequisite to success.

Being able to compellingly lobby for the prioritisation of Tax must be the way forward



Conclusion

In conclusion, the world of securities taxation is in a state of flux. Custodians need to be ready to deploy an agile approach in the face of a myriad of activity described above, and clients need to remain vigilant to maximise performance whilst maintaining rigorous compliance standards. In our capacity as a Custodian, J.P. Morgan intend for this Whitepaper to provide a useful summary of key tax considerations. We will continue to drive forward our tax strategy in alignment with valued input from our clients.

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