

Client Alert

Latham & Watkins
Tax Department

UK Stamp Duty Reserve Tax Charge on an Issue of ADRs is Illegal

Summary

The UK First-tier Tax Tribunal has held in *HSBC Holdings plc and the Bank of New York Mellon Corporation v HMRC* [2012] UKFTT 163 (TC), that the 1.5 percent UK stamp duty reserve tax (SDRT) charge on the issue of shares to a depositary receipt system relating to an issue of American Depositary Receipts (ADRs) is contrary both to the Capital Duties Directive (the CDD) and the EC Treaty. The decision also applies to a transfer of shares to a depositary receipt system where the transfer is integral to the raising of new capital.

Following the decision, companies that have suffered the 1.5 percent SDRT charge in various circumstances should consider whether to claim a refund from HM Revenue & Customs (HMRC). The judgment will also be relevant to companies looking to use depositary receipts and clearance systems in future acquisitions or other capital-raising transactions. HMRC confirmed on 27 April 2012 that it will not seek permission to appeal the decision and it is inviting statutory claims for repayment under the Stamp Duty Reserve Tax Regulations 1986 (the SDRT Regulations).

Facts

HSBC formed a subsidiary company, (SubCo), to acquire a target (Target). Target was merged with SubCo, its legal existence ceased, its shares were cancelled and all its assets and liabilities were transferred to SubCo. In return, each Target shareholder could elect to receive either a number of HSBC shares, or ADRs backed by those shares.

HSBC shares were allotted to an exchange agent (the Exchange Agent) for the benefit of Target's common stockholders on bare trust as custodian. The Target shareholders who elected to receive them were transferred the shares from the Exchange Agent. The Target shareholders who elected to receive ADRs were issued the ADRs by Bank of New York Mellon (BNY). Where an ADR was issued by BNY, the Exchange Agent would transfer an equivalent number of shares to BNY's custodian (Nominee Co) after a period of time, known as a "flowback period," had elapsed. If the ADRs were cancelled by a Target shareholder (or a subsequent transferee) during this flowback period (because the shareholder or transferee preferred to hold HSBC shares directly) there would be no need to transfer the shares to Nominee Co, and it was agreed that no SDRT charge would arise.

"Companies should consider whether they are able to claim a repayment of SDRT, while ensuring future transactions are structured such that no adverse UK tax consequences arise."

SDRT was accounted for to HMRC at 1.5 percent on the transfers of shares from the Exchange Agent to Nominee Co (*i.e.*, relating to those ADRs that were not cancelled), pursuant to section 93 of the Finance Act 1986 (FA 1986). Section 93 FA 1986 broadly imposes an SDRT charge of 1.5 percent where a depositary has issued or is going to issue a depositary receipt (such as an ADR) and equivalent chargeable securities are transferred or issued to a depositary.

HSBC and BNY appealed against this 1.5 percent charge and sought to reclaim the SDRT paid.

Issues

Certain key points of relevance to transactions involving the issuance of depositary receipts including ADRs were determined by the Tribunal:

- Whether the Target shareholders retained their beneficial interest in the HSBC shares when those shares were transferred by the Exchange Agent to Nominee Co.
- Whether the SDRT charge contravened Articles 10 and/or 11 of the CDD (and, if so, whether Article 12 could be relied upon to permit the charge).
- Whether the SDRT charge was unlawful under Article 56 of the EC Treaty (free movement of capital).

Decision

ADR Holders' Interest in the HSBC Shares

The taxpayers had argued that the transfer of HSBC shares from the Exchange Agent to Nominee Co was a transfer of legal title only, that the holders of the ADRs retained the beneficial interest in the underlying shares and that the requirements of section 93 FA 1986 were therefore not met. Instead, only a £5 fixed SDRT charge on non-sale transfers of shares should apply.

After reviewing conflicting expert evidence, the Tribunal decided as a matter of fact that, under US law, the relevant ADR holders did not hold a beneficial interest in the underlying shares. There was nothing in the relevant contracts expressly creating a trust relationship between the ADR holders and the depositary, and nor was such a relationship implied. This finding contradicted HMRC's own guidance that holders of depositary receipts do have a beneficial interest in the underlying shares.

Further, even if the beneficial interest had been retained by the Target shareholders such that the transfer to Nominee Co was of legal title only, section 93 FA 1986 would still have applied and SDRT would have been chargeable at 1.5 percent (rather than a £5 fixed charge as claimed by the taxpayers).

Articles 10 to 12 of the CDD

Article 10 of the CDD prevents states from imposing a tax or duty, other than capital duty, on increases of the capital of a company through the contribution of assets.

Article 11 of the CDD similarly prevents taxes or duties on the issuing of securities by a company.

The Tribunal held that the SDRT charge in this case contravened both Article 10 and Article 11, as the transfer of shares from the Exchange Agent to Nominee Co in respect of which the SDRT charge arose was integral to the raising of new capital by HSBC. Article 12 of the CDD, which permits taxes on transfers of shares, did not permit the SDRT charge. The Tribunal held that the CDD should be interpreted purposively and that Article 12 should be interpreted narrowly. Given that the relevant transfer in this case was integral to the raising of capital from investors by a

company issuing shares, to permit an exception under Article 12 would be to defeat the purpose of the CDD.

In reaching its conclusions, the Tribunal held that it did not matter that the transfer was not a necessary part of the transaction (in the sense that the transaction could have been structured in a way that did not involve such a transfer), nor was the motive for using the unnecessary step relevant. The Tribunal was concerned only with the structure that was actually used.

HMRC had also argued that the transaction was outside the scope of the CDD because the investors were not resident in the EU. The Tribunal rejected this argument, holding that the decisive factor is whether the company raising capital, in this case HSBC, is registered in the EU. The residence of the investors is not relevant.

The Tribunal suggested that, if HSBC had issued the shares directly to BNY the 1.5 percent SDRT charge would equally have been illegal and repayable.

Article 56 of the EC Treaty

Although the decision in respect of Articles 10 and 11 of the CDD was sufficient to find in favour of the taxpayer, the Tribunal also considered Article 56 of the EC Treaty.

Article 56 prohibits restrictions on the free movement of capital, including movements to and from countries from outside the EU. The Tribunal held that the transaction in this case, involving the transfer of shares in an EU-resident company by a non-resident investor to a resident investor, fell within the protection of Article 56 as a cross-border movement of capital.

If HSBC had chosen to raise capital in the UK it would not have been necessary to issue ADRs and, consequently, there would have been no liability to SDRT. The charge in this case was therefore discriminatory and unlawful.

As a result of the decision it is also likely that the SDRT charge currently imposed on issuing any "chargeable securities" of an EU company into a non-EU based clearance service is illegal.

Implications of the Decision

Repayment for Past Transactions

HMRC has announced that it will not seek permission to appeal against the decision and will make repayments of SDRT where companies have issued shares (or transferred shares as an integral part of an issue of share capital) in UK-incorporated companies to depositary receipt issuers or clearance services within or outside the EU.

Companies that have incurred the 1.5 percent charge in equivalent circumstances should consider issuing claims for repayment (plus interest). Companies should also consider claims for SDRT paid in other comparable situations to which the decision in this case may apply, for example: (a) where an SDRT charge has arisen from securities other than shares (as it is likely that the Tribunal's decision will apply equally to instances in which capital is raised by way of debt rather than equity); and (b) where 1.5 percent bearer instrument duty has been suffered on an issue of shares.

Claims for repayment of SDRT should be made within a period of four years beginning with the later of: (a) the date on which tax was paid and (b) the relevant accountable date for payment under the SDRT Regulations. Companies that have

suffered the 1.5 percent SDRT charge more than 4 years ago should also consider seeking advice as to the potential for reclaiming the SDRT paid. Currently HMRC would consider such a claim to be outside the relevant limitation periods and litigation may be required to pursue such a claim.

The position is less promising for selling shareholders who have in the past transferred their existing shares to a depositary as part of an ADR programme. Such shareholders would have to demonstrate that the relevant transfer was "integral" to raising of new capital in order to have a prospect of claiming repayment.

Structuring Future Transactions

The decision in this case follows the ECJ decision in *HSBC Holdings plc and Vidacos Nominees Ltd v HMRC* (C569/07) (which held that the imposition of SDRT on an issue of securities into a clearance service is contrary to EU law) and confirms that the *Vidacos* decision extends to the issuing of depositary receipts. Companies should now be able to use these instruments in future acquisitions or other capital-raising transactions (both within and outside the EU) without triggering the 1.5 percent SDRT charge. However, HMRC does not consider that the decision affects a transfer (whether by sale or otherwise) of shares or securities to clearance services or to depositary receipt systems where the transfer is not an integral part of the issuance of capital. In such circumstances, an SDRT charge will continue to apply.

The decision of the Tribunal raised other issues of potential relevance for future and existing transactions, in that it was held that, as a matter of fact under New York law, the holders of the ADRs did not have a beneficial interest in the relevant underlying shares. This is contrary to the previously generally considered view of the position in such transactions and raises potential uncertainty as to the taxation treatment of transactions involving ADRs. HMRC has amended its guidance to state that "the holder of a typical ADR issued in accordance with New York state law will typically not be the beneficial owner of the underlying shares." The decision was based on the specific facts of the case. However, it raises the spectre, depending on the particular transaction, of potential charges to SDRT and/or capital gains tax arising upon transfers of shares between depositary receipt holders and issuers. Until HMRC's position in respect of such transactions is clarified it will be imperative that companies seek advice to ensure that proposed transactions do not give rise to unwanted UK tax consequences.

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