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X/N System and Belgian withholding tax exemption extended to structured notes.

A recent Royal Decree has extended the categories of debt securities that can be admitted in the X/N System operated by the National Bank of Belgium ("**NBB**"). Certain structured securities such as inflation-linked and index-linked notes can henceforward be admitted in the X/N System, provided that the accrued interest can be calculated on the basis of a formula which is acceptable to the NBB (see Royal Decree of 1 July 2013 amending the Royal Decree of 26 May 1994 on the deduction and compensation of withholding tax in accordance with chapter I of the Law of 6 August 1993 in relation to transactions with certain securities, published in the Belgian State Gazette of 9 August 2013).

These changes apply to securities issued as from 1 January 2013.

As a result, the broad Belgian interest withholding tax exemption for securities admitted to the X/N System can be applied to such structured notes, which facilitates direct access to the international capital markets for Belgian issuers.

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1 Background

1.1 The X/N System

The National Bank of Belgium operates a securities settlement system for debt securities (the "**X/N System**").

Government bonds as well as debt securities issued by Belgian or foreign private issuers (and governed by Belgian or foreign law), can be admitted in the X/N System. This includes stand-alone bonds but also notes issued under note programmes (EMTN), commercial paper, treasury notes, etc.

Interests in debt securities admitted to the X/N System are represented by entries in securities accounts maintained with the NBB itself or participants or sub-participants in such system (including Euroclear Bank and Clearstream Banking). Debt securities accepted in the X/N System are usually issued in dematerialised form and are freely transferable.

1.2 The X/N interest withholding tax exemption

A key feature of the X/N System is the special Belgian withholding tax rule under which investors are required to hold their securities either on an exempt account (X-account) or a non-exempt account (N-account) depending on their withholding tax status:

- All non-residents of Belgium and all Belgian companies (and certain other entities) are entitled to hold their securities on an X-account. Interest on securities held on X-accounts are exempt from Belgian interest withholding tax.
- Other investors (mainly Belgian resident individuals and most Belgian non-profit organisations) are required to hold their securities on an N-account. Interest on securities held on N-accounts will be subject to 25%[1] Belgian interest withholding tax, which will be deducted and paid to the Belgian treasury by the NBB.

Securities are traded on a gross basis in the X/N System, although the accrued interest constitutes taxable income for N-account holders. Therefore, in the case of a sale of securities between two interest payment dates, or prior to maturity, the NBB will calculate the accrued interest and deduct the 25% withholding tax if the seller is an N-account holder; if on the other hand the buyer of the securities is an N-account holder, he will be granted a refund equal to the withholding tax on the accrued interest (as he will have purchased gross while being subject to withholding tax on the coupon).

Holding debt securities through the X/N System enables X-account holders to receive gross interest income on their securities and to transfer the securities on a gross basis. The X/N system therefore facilitates access to the international capital markets for Belgian banks, corporates and finance vehicles.

2 Extension of categories of debt securities that can be admitted in the X/N System – structured notes

2.1 Situation to date

Until recently, the X/N System was limited to debt securities the nominal interest rate of which could be determined upon issuance (fixed rate bonds and zero coupon bonds) or at the beginning of the coupon period on the basis of variable parameters (floating rate bonds).

Debt securities the return of which is wholly or partly linked to an underlying value (inflation, share index, gold price, currency, *etc.*) could not be admitted as there was no legal framework for calculating

[1] 15% withholding tax applies to interest on government bonds issued during the period from 24 November to 2 December 2011 and which are subscribed during that same period.

the accrued interest component in the case of a sale between two interest payment dates (see above).

2.2 Structured notes

The Royal Decree of 1 July 2013 now provides how to calculate the accrued interest on such securities. The accrued interest is calculated on the basis of the formula for determining interest as contained in the terms and conditions of the securities concerned, but taking into account the value of the relevant parameters (*e.g.* inflation, value increase of the index) at the date of the transaction (*i.e.,* the transfer of the securities between two interest payment dates or before maturity).

If the interest has a fixed rate component, the accrued interest on this component will be the fixed rate prorated to the number of days that have run since the previous interest payment date or the issue date.

<u>Example 1 without periodic coupon</u>

A note with a denomination of EUR 1,000 will be reimbursed after 5 years with interest amounting to 70% of the price evolution of one ounce of gold. The price of one ounce of gold upon issuance is USD 1,100. The note is sold before maturity. If one assumes that the price for one ounce of gold is equal to USD 1,210 at the time of the sale, the accrued interest will be calculated as follows:

70% x [(1210-1100) / 1100] x EUR 1,000 = EUR 70.

<u>Example 2 with periodic coupon</u>

An inflation-linked note with a denomination of EUR 1,000 bears an annual coupon payable on 15 April linked to the annual evolution of the consumer price index (base 2004) ("CPI") of February plus 1.5%.

In the case of a sale on 27 August 2013, the accrued interest is calculated as follows:

[(122.53-122.02) / 122.02 + (134/365) x 1.5%] x EUR 1,000 = EUR 9.69

<u>Whereby:</u>

122.53 =	CPI at the time of the transaction (2nd month preceding the transaction, *i.e.*, June 2013);
122.02 =	reference CPI (February 2013);
134 =	numbers of days that have run in the current interest period;
365 =	total number of days of the interest period;
EUR 1,000 =	denomination of the note

The accrued interest calculation is a lump-sum amount which deviates from, and may be higher than, the interest that will be collected by the holder upon the next interest payment date or upon maturity. Furthermore, it is unclear whether account will be taken of the price at which the debt security is traded.

2.3 Approval of calculation formula by NBB

The Royal Decree explicitly provides that the accrued interest calculation rule only applies if the NBB approves the formula (*i.e.,* the formula for calculating the interest or redemption amount as included in the terms and conditions of the notes) from an operational point of view. In other words, the NBB may refuse to accept the notes in the X/N System if the formula is too complex or if the reference value is not easily accessible.

We expect some standardisation of the calculation formulas that the NBB is able or prepared to manage, with the number and complexity of calculation formulas being limited at least in the first stage. Until now, the NBB has not publicly provided guidance in this respect.

2.4 Impact

The Royal Decree constitutes an important improvement of the X/N System. Index-linked and similar structured notes can be an important source of funds for Belgian issuers but, until now, such notes had to be excluded from their Belgian-based note issuance platforms in the absence of a Belgian withholding tax exemption for foreign investors. The broad Belgian interest withholding tax exemption offered by the X/N system can now be used for such structured notes issued by Belgian governments and private issuers, which facilitates their direct access to the international capital markets.

3 Belgian tax treatment of structured notes – Administrative Circular Letter of 25 January 2013

Although the formal extension of the X/N System to (certain) structured notes is to be welcomed, the question arises whether the accrued interest calculation method is in all circumstances in line with the Belgian income tax code.

Indeed, according to the Belgian income tax code, only a transfer of “fixed income securities” gives rise to a taxable “accrued interest” for the seller in the case of a sale between interest payment dates or before maturity. “Fixed income securities” are defined as “bonds, bank savings certificates or other similar securities”. In this respect, the Royal Decree of 1 July 2013 assumes that structured products generally qualify as fixed income securities. The report to the King accompanying the Royal Decree states that tradable securities that constitute a “receivable” as a result of “a capital investment” are “similar to bonds”.

This statement is in line with the position defended by the central tax administration in a circular letter dated 25 January 2013 relating to the Belgian tax treatment of income from structured notes. In the circular letter, structured notes are defined as securities the return of which is linked to an underlying value (share basket, index, etc.) and the terms and conditions of which include one or more of the following features: (a) a (conditional) minimum return; (b) capital protection; (c) a periodic coupon payment; and (d) determination of income at an intermediary stage using a "ratchet" system. The circular letter takes the position that such structured notes qualify as "fixed income securities" giving rise to taxable "accrued interest" in the hands of the selling noteholder. For Belgian resident individual noteholders holding notes outside the X/N System this would mean that the accrued interest income must be declared in their annual personal income tax return.

The Royal Decree of 1 July 2013 (and the accompanying report to the King) now confirms and clarifies the Belgian tax administration's intention to apply the principles set forth in the circular letter.

It remains, however, highly debatable whether such structured notes generally qualify as "fixed income securities", especially in the absence of capital protection and a fixed interest component. On the basis of the criteria upheld by the administrative circular and in the royal decree, it is difficult to think of debt securities which do not qualify as "fixed income securities". Furthermore, as indicated above, the accrued interest calculation method results in a lump-sum valuation of taxable income. It is recommended that the Belgian legislator clarify the Belgian income tax treatment of structured notes.

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