

## Table of Contents

|   |     |
|---|-----|
| [2] Solutions to Problem 7: Improving the General Design of the Tax System and Introducing Effective Anti-avoidance Legislation | 253 |
| §11.04 Outlook  | 253 |
| ANNEXES   |     |
| Annex to Chapter 4  | 257 |
| Annex to Chapter 5  | 267 |
| Annex to Chapter 8  | 305 |
| Annex to Chapter 9  | 321 |
| Annex to Chapter 10   | 325 |
| Bibliography  | 335 |
| Table of Cases and Decisions  | 359 |
| Table of National Legislation   | 365 |
| Table of Statutory Instruments, Legislative Material and Other Official Documents   | 369 |
| Table of Double Taxation Conventions, OECD and UN Model Conventions and Other OECD Materials                                    | 377 |
| Table of Financial Accounting Standards and Other Materials   | 383 |
| Table of ISDA Documents   | 391 |
| Index   | 393 |

## Preface

This work aims to provide an analysis of various corporate taxation issues arising in domestic as well as in cross-border derivatives transactions. It is structured around seven problems in the taxation of derivatives that I have identified as particularly relevant. Each taxation problem is dealt with in a separate chapter.

These 'problem chapters' discuss both the UK and German legislative approach to deal with the specific taxation problem in a first step and in a second step analyse, evaluate and compare those approaches, including the strengths and weaknesses of the approaches. At the end of each chapter, I propose solutions on how to deal with the specific derivatives taxation problems.

Although the analysis in this work is mainly based on the existing tax legislation in the UK and Germany, the work is not aimed to be a comparative work of domestic tax legislation dealing with derivatives. Rather, it engages in a broader discussion of both general and specific issues at the level of the domestic tax legislation as well as problems on an international level. A comparison of the specific tax legislation in the UK and Germany and the analysis of practical examples allow a differentiated discussion of problems and possible solutions that can be adopted in the context of derivatives taxation, thereby avoiding a one-sided view on how to deal with those issues from the perspective of only one country's tax legislation.

The work contains 11 chapters. Chapter 2 explains the economic basics of derivatives. In Chapter 3, I identify the various taxation problems that derivatives may create at a national and international level. Chapters 4–10 are specific 'problem chapters' where each of the seven problems which were identified in Chapter 3 are dealt with. After an evaluation of the advantages and disadvantages of the taxation solutions implemented by the UK and Germany, I have suggested at the end of each 'problem chapter' solutions how domestic tax legislators as well as international bodies like the OECD may be able to deal with these problems coherently. These solutions have also been specifically evaluated in relation to the question whether they are appropriate to tackle tax avoidance schemes that utilise derivatives.

The discussions in these chapters have also incorporated a discussion of various tax policy issues as well as practical application problems arising in domestic as well as cross-border derivatives transactions. In the conclusion, I sum up my evaluation of the

after reset date 4 (after 12 months), Company A will receive 0.5% at date 1, 0% at date 2 and 3 and 1% interest at date 4, thereby effectively protecting the Company against interest rates rising above 3%. No payment is made to Company A by the counterparty of the cap if interest rates fall below 3%.

Generally speaking, a cap effectively limits the maximum price of the underlying or the level of the index for the short position holder of the cap. For the long position holder of the cap, it effectively provides insurance against rising interest on a floating rate note or swap interest above a pre-agreed cap level.<sup>22</sup> In contrast, a floor agreement provides downside protection and payments will be made to the holder of the long floor position<sup>23</sup> if the price of the underlying asset, index or rate falls below a pre-agreed value.<sup>24</sup>

A collar agreement is effectively a combination of a short call option and a long put option over an underlying index, asset or other variable, where a lower and an upper strike price is agreed.

#### Example 3:

In case of interest rate collars, A makes periodic payments to B if the interest rate rises above the specified upper level,<sup>25</sup> whereas B makes periodic payments<sup>26</sup> if the interest rate drops below the pre-agreed lower level.<sup>27</sup> The interest rate collar is a combination of an interest rate cap and an interest rate floor.<sup>28</sup>

An equity collar hedges against share price losses below a certain minimum price (put strike), whereas the investor can still participate in the share price appreciation up to the level of the call strike.

Similarly, a put spread can be used as a limited hedge against falling pricing of the underlying assets, for example shares. A put spread is a combination of a long put option with a high strike price and a short put option with a lower strike price. The investor buys the put option to protect himself from the downward movements and sells the put at a lower strike price to partly finance the option premium paid under the first put option. The initial downside protection of the first put is thus limited to the strike price of the second put option.

By combining and amending these basic forms of derivatives, financial engineers have developed a great variety of derivatives with exotic features and incorporated

22. *Ibid.*, 619; also: Wilmott (2000) 450 (at the example of interest rates as an underlying).

23. This position is effectively a long put position.

24. Hull (2006) 620; Wilmott (2000) 450.

25. Which equals the short call position for A.

26. Which equals the short put position for B.

27. Natenberg (1994) 265; OECD (2001) para. 27.

28. Hull (2006) 751.

derivatives into structured products to meet the investment objectives and risk features required by the financial institutions and corporate investors alike.<sup>29</sup>

#### [B] Categorisation of Derivatives According to Their Underlying Variable

Derivative contracts can also be categorised according to their specific 'underlying asset' or 'underlying variable'.<sup>30</sup> Basic forms of derivatives based on their underlying are equity derivatives, fixed income derivatives, commodity derivatives, currency derivatives and credit derivatives.

Equity derivatives are all derivatives which are derived from the price of an underlying equity asset, a basket of equities, an equity index, or from the value of the payment streams of the equities, i.e., the dividends.

Fixed income derivatives are all derivatives that are derived from either the price of bonds, baskets of bonds or bond indices, or from interest rates.

FX derivatives are those derivatives which have the price of one or more currencies as the underlying variable. Commodity derivatives are derived from the price of physical commodities, such as silver, wheat, soya, crude oil, etc. Credit derivatives are derivatives whose payoffs depend on the probability of a credit event in relation to government, corporate or other bonds, or a credit event occurring in relation to a defined creditor.<sup>31</sup>

#### §2.02 BASIC TERMS: REPLICATION, HEDGING OF DERIVATIVES AND LEVERAGE

##### [A] Economic Replication

Replication in general means that it is at any time during the term of the derivative possible to replicate the total sum of the payoffs of the derivative by entering into a trading strategy using other financial instruments, including basic underlying assets, cash and other derivatives.<sup>32</sup>

A derivative can be replicated by entering into other financial instrument(s), if at maturity of the derivative, the financial instrument(s), which replicate the derivative, have in sum the same *payoff* as the derivative, meaning the sum of all cash flows<sup>33</sup> of

29. Edgar (2000b) 290 considers the aspect of combining derivatives as critical for tax policy purposes.

30. For the distinction between the term underlying asset and underlying variable, see Ch. 4 s. §4.06[B][1].

31. See also Annex, §A4.01[C].

32. Rubinstein (1999a) 71–72 and 179–192. See: OECD (2001) paras 31–41 for a general discussion of the concept of replication and its importance in the context of tax law.

33. Cash flows of a derivative are one or more payments, which at certain points in time during the term of the derivative either inflow or outflow; see: Peter Newman, Murray Milgate and John Eatwell (eds), *The new Palgrave dictionary of money and finance* (Macmillan 1992).



of income. Or, the general tax rules that also apply to derivatives may be too unspecific in their application, thereby leading to an overtaxation<sup>3</sup> or undertaxation<sup>4</sup> of certain income or gains from derivatives.

In case of a special tax regime applying to derivatives, problems may arise if the special regime is tailored only to existing derivatives and is not able to incorporate newly emerging instruments, thereby causing a time lag between the development of new financial products and the introduction of specifically targeted tax legislation. Constant financial innovation of new types of derivatives and the use of unusual underlyings may therefore challenge the ability of tax systems in defining derivatives for tax purposes.<sup>5</sup>

A 'static' definitional approach may lead to tax arbitrage opportunities as certain instruments may not meet the words or the interpretation of the existing tax legislation. Tax arbitrage schemes may indeed be designed to fall either in or outside the scope of the derivatives definition (depending on the aim that the particular scheme is pursuing).<sup>6</sup> At the same time, a static definition may deter taxpayers from entering into derivatives transactions because of the unknown tax treatment of newly emerging derivatives.

Different definitions of derivatives used by different countries can also pose a serious obstacle to a coherent taxation of derivatives in cross-border transactions. The application of tax treaties in those transactions can create difficult legal issues of interpretation because derivatives and hybrid instruments<sup>7</sup> can often not be classified unambiguously under the existing articles of double tax treaties.<sup>8</sup>

Treaty classification conflicts are likely to arise in cross-border transactions if one country qualifies the income, gains or losses from derivatives as a different category of income than the other country and therefore applies different taxation rules.<sup>9</sup> Thus, it may be uncertain in those cases under which article of the double tax treaty the income will fall, as neither the OECD Model nor the UN Model define the term 'derivative'.

3. For example, a general tax system may not only tax net gains and losses under an interest rate swap, but all different payment streams under the swap without allowing the netting of those payment streams for tax purposes due to the application of general rules.

4. For example, undertaxation of certain derivatives income may occur in a general tax system if gains from cash settled equity derivatives would fall under the normal taxation rules of debt gains and be fully taxable, whereas gains from the disposal of shares under physically settled equity derivatives would be tax-exempt under the general rules.

5. Neighbour (2001) 1; Strnad (1994) 569; Thuronyi (2001a) 261; Warren (1993) 461.

6. Thuronyi (2001a) 263.

7. For a definition of the term, see Ch. 8 s. §8.03. Emphasising the debt/equity character, but applying it to a slightly broader range of instruments: Neighbour (1997) 932; Thuronyi (2001a) 262; Victor Thuronyi, *International Tax Aspects of New Financial Instruments* (in: Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, UNPAN conference documents, 2001) 7.

8. Thuronyi (2001a) 264; Thuronyi (2001b) 3; also: OECD (2001) para. 63.

9. Thuronyi (2001a) 265.

### §3.02 PROBLEM 2: A SPECIAL TAXATION REGIME VERSUS THE APPLICATION OF GENERAL TAX RULES TO DERIVATIVES, AND THE DISTINCTION OF INCOME AND CAPITAL, AND EQUITY AND DEBT

#### [A] Specific Taxation Regime versus the Application of the General Tax Rules

Derivatives may be seen as a third category beyond equity or debt.<sup>10</sup> In this respect, the legislator may choose to design a separate taxation regime for derivatives.<sup>11</sup> Alternatively, tax systems may apply the existing set of tax rules.<sup>12</sup> Again other legislators may decide to apply a separate set of rules to derivatives, but maintain the distinction between equity and debt in the context of those rules.<sup>13</sup>

In the context of all approaches, problems in the taxation of derivatives are likely to occur if tax systems distinguish 'in [the] taxation [rules] according to the character of income',<sup>14</sup> for example if capital gains are subject to a more favourable tax regime or lower tax rates than other income.<sup>15</sup> Issues can also arise, if the tax legislator treats returns from equity differently compared to returns from debt, for example privileges equity over debt capital gains, or dividends over interest.

#### [B] The Taxation Rules for Income and Capital Gains Applying to Derivatives

Tax systems may distinguish between transactions that are entered into in the course of a trade or business and those transactions with an underlying investment purpose.<sup>16</sup>

Although in many countries capital gains belong to the normal corporate income tax base,<sup>17</sup> some countries still privilege capital gains, in many cases equity capital gains, in their corporate tax computation, by way of lower tax rates, deferral, adjustment for inflation or exemption from tax.<sup>18</sup> Correspondingly, capital losses may not be offsettable against ordinary income or are not offsettable at all if a capital gains tax exemption applies.<sup>19</sup>

10. OECD (2001) para. 66.

11. In this scenario, the legislator would classify derivatives as a third category that is distinguished from equity and debt instruments and would treat them completely separately for tax purposes from equity and debt instruments.

12. Germany applies this approach to derivatives held by companies.

13. The UK taxes derivatives by applying a completely separate set of rules. Within the derivative contracts regime, a distinction between equity derivatives, which in certain cases are still taxed as capital gains, and other derivative contracts, which are rather attributed to the debt category, is still being made. See: Southern (2012) para. 1.9.

14. Thuronyi (2001b) 1.

15. Thuronyi (2001a) 263; Thuronyi (2001b) 1.

16. Laukkanen (2007) 127; OECD (2001) para. 49; Thuronyi (2001b) 1.

17. Both in Germany and the UK, capital gains form a part of the corporate income tax base.

18. OECD (2001) para. 49; Thuronyi (2001b) 1. Also: Laukkanen (2007) 129 who provides examples of special capital gains rules in different countries.

19. OECD (2001) para. 49.



comprehensively.<sup>14</sup> [A]ll profits arising to a company from its derivative contracts are chargeable to corporation tax as income in accordance with [CTA 2009, Part 7].<sup>15</sup> Only derivative contracts entered into by companies are subject to the provisions of CTA 2009, Part 7.<sup>16</sup> The 'derivative contracts legislation' of Part 7 applies to both single derivative contracts and embedded derivatives, provided they are bifurcated from a 'loan relationship' host contract under UK GAAP<sup>17</sup> or IAS.<sup>18</sup>

In order to qualify as a derivative contract under CTA 2009, Part 7, a contract must satisfy three tests under CTA 2009, Part 7:<sup>19</sup>

- (a) It must be a 'relevant contract'.<sup>20</sup>
- (b) It satisfies the 'accounting conditions' for the accounting period in question,<sup>21</sup> or if not meeting the 'accounting conditions', it is a commodity-based derivative or certain type of contract for differences.<sup>22</sup>
- (c) It must not be excluded from being a derivative contract by virtue of its underlying subject matter<sup>23</sup> or by any other provision of CTA 2009.<sup>24</sup>

#### [a] Relevant Contract

A derivative contract is a 'relevant contract' within the scope of CTA 2009, Part 7 if it qualifies as an 'option',<sup>25</sup> a 'future'<sup>26</sup> or a 'contract for differences' (CFD).<sup>27</sup> All three definitions will have a wide meaning and only the definitional criteria 'accounting conditions' and 'exclusions' narrow down the scope of a derivative contract.<sup>28</sup> One has

14. Julian Ghosh, Jan Johnson and Paul Miller, *Taxation of Corporate Debt and Derivative Contracts* (LexisNexis Butterworths 2009 with updates through Issue 2, June 2010) [E2.34]. See also an older version of: Richard Bramwell and others, *Taxation of Companies and Company Reconstructions* (8th edn, 2002) A5A.1.1 (R 2, Nov 2002).
15. CTA 2009, s. 571(1). FA 2002, Schedule 26, formerly applicable to 'derivative contracts' has been substituted by CTA 2009, Part 7 in the course of the Tax Law Rewrite project. It can be presumed that consolidation acts, such as CTA 2009 Part 7 do not change the pre-existing law as such. See: *Beswick v. Beswick* [1968] AC 58 (HL) 73; HMRC, *Corporation Tax Act, Explanatory Notes* (2009): 'The Act does not generally change the meaning of the law when rewriting it.'; also: Ghosh, Johnson and Miller (2010) [E2.27].
16. CTA 2009, s. 578(1). See: Julian Ghosh, Jan Johnson and Paul Miller, *Taxation of Corporate Debt and Derivative Contracts* (LexisNexis Butterworths 2009 with updates through Issue 8, July 2013) [E2.61].
17. UK GAAP is the abbreviation for UK *Generally Accepted Accounting Practice*.
18. CTA 2009, s. 585(1)-(3). See: Richard Bramwell and others, *Taxation of Companies and Company Reconstructions*, vol 2 (9th edn, 2009 with updates through December 2010) H.1.2.4; Southern (2012) para. 13.2.
19. CTA 2009, s. 576(1)(a)-(c).
20. CTA 2009, ss 576(1)(a), 577(1).
21. CTA 2009, s. 579(1).
22. CTA 2009, s. 579(2)(a), (b).
23. CTA 2009, s. 589.
24. CTA 2009, s. 576(1)(a)-(c). See: Ghosh, Johnson and Miller (2010) [E2.96]-[E2.120]; *Tolley's Corporation Tax 2010-11* (LexisNexis UK) [29.3].
25. CTA 2009, s. 580(1).
26. CTA 2009, s. 581(1).
27. CTA 2009, ss 577(1), 582.
28. Ghosh, Johnson and Miller (2010) [E2.96]-[E2.120].

to distinguish between options and futures on the one hand, and CFDs on the other, because there are differences in the taxation of those instruments.<sup>29</sup>

#### [i] Futures

A future is defined in the CTA 2009, Part 7 as a:

contract for the sale of property under which delivery is to be made:

- at a future date agreed when the contract is made; and
- at a price so agreed.<sup>30</sup>

Again, this definition has a very wide scope and includes forwards, i.e., contracts which are non-standardised OTC transactions.<sup>31</sup> This is in contrast to the economic definition of a future where a distinction between exchange-traded futures and OTC forwards is made.<sup>32</sup>

Because the scope of the definition is wide, one might argue that physically settled (equity) price swaps<sup>33</sup> as well as physically settled total return (equity) swaps<sup>34</sup> would fall under the wording of the definition of future under CTA 2009, section 581.

#### Example 17:

Party A enters into a physically settled total return equity swap with Party B over three years. The underlying shares are shares of Company Z. Under the swap, Party A will pay Party B any dividends when received and Party B will pay Party A periodically interest payments.

At maturity, Party A will deliver shares in Company Z to Party B. Thus, Party B will be economically exposed to the price of the shares during the term of the swap without physically holding the shares until maturity of the swap.

29. These differences occur for example in the context of excluded underlying subject matter, being intangible fixed assets, CTA 2009, s. 589(4). See Annex, §A5.01[C]. Furthermore, different accounting tests apply to option and futures on land, and CFDs on land. See Ch. 4 s. §4.03[A][2][b].
30. CTA 2009, s. 581(1).
31. See: Statement of Practice 03/02 which indicates the wide range of the term; also: Ghosh, Johnson and Miller (2010) [E2.145].
32. Hull (2006) 6.
33. Under an equity price swap, one party owes any upside movement of the shares to the other party and has the right to get expensed for any downside movement of the shares. Because the swap is physically settled at maturity, the obligations are fulfilled by delivery of the underlying instrument. No dividend payments are made under a price swap.
34. Under a total return equity swap, not only the upside or downside movement of the shares is exchanged under the swap, but any dividends received and interest paid. Thus, even in case of physical settlement of the swaps, (manufactured) dividend and interest payments will be made periodically during the term of the swap.



markets legislation will not serve sufficiently the aim of defining derivative contracts for tax purposes.

- (4) In Chapter 4 section §4.03[B][1] and §4.03[B][2], I have illustrated that an unambiguous determination of the exact scope of the term in relation to cash and physically derivatives is hardly possible because of the rather imprecise wording in the law, leading to different points of view in the German tax literature.

In order to avoid the uncertainty in the scope of the term *derivative contract* used in sections 20(2) sent 1 No. 3a) and 15(4) sent 3 ITA, it is imperative from a systematic point of view that the term is defined comprehensively and unambiguously both in the tax legislation for private individuals, as well as in the tax legislation for business investors.

#### §4.04 OTHER DEFINITIONAL APPROACHES

##### [A] Different Approaches to Defining Derivatives in Other Countries

In the tax legislation of other countries, one can find different approaches to defining derivative contracts for tax purposes that can be categorised according to the criteria outlined in Chapter 4 section §4.02 of this work.

Switzerland simply uses the economic definition of derivatives to categorise them also for tax purposes as there are no special rules for taxing derivatives in the legislation.<sup>169</sup>

The US legislator has not developed a comprehensive definition of derivatives for tax purposes. Instead, forwards, futures, options, swaps and similar financial products are subject to different sets of tax rules.<sup>170</sup> As the tax treatment can be substantially different, it is critical to determine which sets of rules are applicable to the particular transaction. In addition, the tax rules governing exchange-traded options and futures are very different from the rules that apply to non-exchange-traded forwards and options. As the US income tax system has no single definition of derivatives, it deals with the different contracts enumeratively by way of statutes, rulings and cases law with the result that many inconsistencies arise and that in many cases the taxation does not reflect the underlying economics.<sup>171</sup>

Australia uses a broad definition of 'financial arrangement' in its Taxation of Financial Arrangement Rules (TOFA)<sup>172</sup> and applies the so-called coherent principles

169. Lionel Aeschlimann, 'Chapter D5: Taxation of Derivatives: Switzerland' in Steven Conlon and Vincent Aquilino (eds), *Principles of Financial Derivatives: US and International* (1st edn, Thomson Reuters/ WG&L 2011) D5.01.

170. Steven Conlon, 'Part B: US Federal Income Taxation of Derivatives' in Steven Conlon and Vincent Aquilino (eds), *Principles of Financial Derivatives: US and International Taxation* (Thomson Reuters/WG&L 2011) B1.01.

171. *Ibid.*

172. Income Tax Assessment Act (ITAA) 1997, Ch 3, ss 230–245, 230–250 and Subdivision 230J.

approach<sup>173</sup> when taxing this form of arrangement.<sup>174</sup> The TOFA rules however do not include a specific definition of derivatives in the legislation but only define more generally 'financial arrangements'.

##### [B] Definition of Derivatives for Tax Purposes in the Academic Tax Literature

Similarly, at the academic level, many attempts have been made by tax experts to define derivatives for tax purposes. Some authors merely define derivatives by way of enumeration of the basic building blocks and include also instruments like mortgage-backed securities and structured notes and hybrid securities.<sup>175</sup>

Zelinsky suggests that 'the term "derivatives", taken literally, is over-inclusive, describing some quite traditional form of investments' and proposes the use of the broad designation of 'New Financial Instruments' instead.<sup>176</sup>

Other authors favour a policy-based approach, which tries to capture both existing and newly emerging derivatives.

For example, Thuronyi argues in favour of a very broad concept of *New Financial Instruments* 'as tax law should be prepared to cover whatever financial instruments the market can devise'.<sup>177</sup>

His argument in favour of such a policy-based approach is that:

the inherent difficulty in defining NFIs [New Financial Instruments] should be kept in mind if an attempt is made to define new financial instruments or specific categories thereof, such as derivatives, in the tax legislation. [...] A detailed definition, unless very carefully structured, can fall prey to tax planners who will parse the definition precisely and devise arrangements that fall outside the scope of the definition if it is in their interest to do so.<sup>178</sup>

Likewise, Romer proposes that tax rules 'need to evolve as new technologies arrive'<sup>179</sup> and suggests that:

if there is a fixed set of rules in something like a tax code, clever opportunists will steadily undermine their effectiveness. They will do this, for example, by changing the names of familiar objects to shift them between different legal categories, or by winning judicial rulings that narrow the applicability of the existing rules. In sum, rules have to evolve in response to three distinct factors: new technologies, increases in the scale of social interaction and opportunistic attempts at evasion.<sup>180</sup>

173. Pinder (2005) 77. Under a coherent principles approach, the principle becomes an operative legislative provision; see: Freedman (2010) 725.

174. Australian Treasury, Exposure Draft: Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, Explanatory Material (2008) 1.19.

175. Wiesenbart and Johannemann (2007) A1.01[3].

176. Zelinsky (1997) 947, at fn 185.

177. Thuronyi (2001a) 262.

178. *Ibid.*, 263.

179. Paul Romer, 'Process, Responsibility, and Myron's Law' (Macro and Growth Policies in the Wake of the Crisis, 7 Mar. 2011) 3.

180. *Ibid.*



### [5] Summary of a Tailor-Made Definition for Tax Purposes

Based on the above considerations, an abstract, comprehensive and self-contained legal definition for tax purposes could look as follows:

- A financial instrument qualifies as a derivative if (and as long as)*
1. its value depends on the value of one or more independent underlying variables,
  2. its payoff is deterministically dependent on stochastic variables, i.e., the payoff depends in an uncertain way on the value of the underlying variable, but the payoff function as such is pre-defined,
  3. it has some future date at which it will mature, and
  4. it is at any time during the term of the financial instrument possible to replicate the sum of its payoffs by following a trading strategy using the underlying asset(s), cash or other derivative(s).

### [C] Application of the Definition to Existing Derivatives

All traditional types of derivatives, such as options, futures, forwards and swaps will fall under the above definition. In particular, it makes no difference for the qualification under the definition whether the derivative is settled in cash or physically, or whether it is sold or novated before maturity as the different forms of settlement do not have an impact on its economic value. Hence, they should not be treated differently with regard to their qualification for tax purposes.<sup>239</sup> Furthermore, it does not matter from which underlying asset or variable the value of the derivative is derived, as long as it is at any time during the term of the derivative possible to replicate its payoff.<sup>240</sup>

In the Annex, I apply the above-developed definition to specific derivatives, like weather derivatives and credit derivatives, and I determine in relation to each of these instruments whether they fall under the derivatives definition or not.<sup>241</sup>

### [D] Introduction of a Definition of Derivatives in Tax Treaties

The problem of how to define a derivative contract also appears at the level of double tax treaties.<sup>242</sup> The OECD Model definitions of interest, dividends, other income, business profits or capital gains may potentially also apply to derivatives income.<sup>243</sup>

In principle, payments or income from derivatives would normally qualify as other income, business profits or capital gains under the OECD Model, and thus would be taxable only in the residence state.<sup>244</sup> It will however depend on the specific tax

treaty and the terms of the specific derivative, under which article of the treaty the respective derivatives payments will be categorised.

Problems of classification of derivatives income or gains may arise because the definitions of 'dividends' and 'other income' are (as a rule) not conclusive in a double tax treaty. Thus, the interpretation of their scope will depend on the national tax law. In certain cases, domestic tax legislation may, for example, include income from dividend swaps and equity swaps into the category of 'dividends' under their national law. Furthermore, interest, although comprehensively defined, may also include certain kind of derivatives income based on the wide meaning of the definition in the OECD Model.<sup>245</sup> Thus, in certain cases, income from interest rate swaps may be treated as interest under the respective treaty.<sup>246</sup>

Hence, it has to be determined on a case-by-case basis under which article of the double tax treaty derivatives income and payments fall as no definition of derivatives income exists in the OECD Model. As a result, the treaty classification of 'derivatives income' will largely depend on how a tax system classifies the income, gains and payments from derivatives under its national law.<sup>247</sup>

Under the UN Model, 'other income' may also be taxed in the source state. Where source countries follow the UN Model, they will be able to impose tax on derivatives income if they qualify derivatives income as 'other income' under their national law.<sup>248</sup>

In my view, a self-contained definition of derivatives as the one suggested above that is incorporated in domestic law could be used to establish whether income belongs to the category of 'derivatives income' in the first place.

A definition of derivatives in domestic tax law can however only provide the basis for solving classification issues in a cross-border context if it is ensured that the qualification of derivatives in national law is consistent with the interpretation at the level of the double tax treaty.

Thus, one should consider whether a separate definition of derivatives in the OECD and UN Model would be of merit. This could be achieved by introducing a further article for income and proceeds from derivatives in the OECD and the UN Model that defines derivatives for tax treaty purposes and applies to common cross-border derivatives transactions. The OECD suggests a:

need to complement existing standards that are designed to prevent double taxation with instruments that prevent double non-taxation in areas previously not covered by international standards and that address cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it.<sup>249</sup>

245. Thuronyi (2001c) 15.

Swap payments could, for example, be treated as interest income under the treaty in cases where the specific tax treaty uses the language of Art. 11 of the OECD Draft Convention (1963) which refers to income that is treated as interest under the laws of the source state.

246. See Ch. 3 s. §3.06[A], Example 13.

247. OECD (2001) para. 62.

248. Thuronyi (2001c) 15.

249. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, 2013) 13.

239. I agree in this respect with the position of Reiner (2002) 341.

240. See Excursus of Ch. 4 s. §4.06[B][1] regarding the distinction between an 'underlying variable' and an 'underlying asset'.

241. Annex, §A4.01.

242. See Ch. 3 s. §3.01.

243. Thuronyi (2001c) 15.

244. Articles 7(1), 13(5) and 21(1) OECD Model.



At maturity, gains and losses from derivatives are taxed as ordinary corporate income.<sup>61</sup> Losses from derivatives<sup>62</sup> may however be subject to the loss ring-fencing provision of section 15(4) sent 3 to 5 ITA.<sup>63</sup> This section is the only provision in the ITA that applies specifically to 'derivative contracts'. It applies not only to non-corporate businesses but also to companies by way of reference.<sup>64</sup>

Under this provision, derivatives losses cannot be offset against other business income of the company but only against other derivatives gains.<sup>65</sup> The losses cannot be carried back or forward to set off against other business income.<sup>66</sup> A loss carry back or forward is only possible against derivatives gains.<sup>67</sup> For a discussion of the exceptions to the derivatives loss ring-fencing rule,<sup>68</sup> see Chapter 5 section §5.04.

#### §5.04 THE DISTINCTION BETWEEN INCOME AND CAPITAL, AND BETWEEN EQUITY AND DEBT IN GERMANY

For corporate tax purposes, both ordinary business income and capital gains are subject to the same tax rate<sup>69</sup> and fall in principle under the sections of the German CTA.<sup>70</sup> Interest received is fully taxable and interest paid is in principle deductible subject to certain exceptions under the debt cap provisions.<sup>71</sup>

Equity investments made by corporate taxpayers are subject to a favourable tax regime that provides a 95% corporate tax exemption for non-portfolio dividends and equity capital gains from the disposals of shares.<sup>72</sup> A total of 5% of the dividends and the capital gains are deemed as non-deductible expenses.<sup>73</sup> Correspondingly, any losses from the disposal of shares or expenses in the context of write-downs in the shareholding are disallowed.<sup>74</sup>

The legislator has exempted equity capital gains from disposal of shares from corporation tax, because the gains have already been subject to corporation tax at the

61. Section 8(1) CTA in conjunction with s. 15(1) ITA.  
 62. See for the discussion whether the section applies only to cash settled derivatives or also to physically settled derivatives: Ch 4 s. §4.03[B][1] and §4.03[B][2].  
 63. Johannemann and Herr (2013) D2.03[6].  
 64. Section 8(1) CTA.  
 65. Section 15(4) sent 1 and 3 ITA.  
 66. Sections 15(4) sent 1 2nd part, sent 3 and s. 10d(1) ITA.  
 67. Section 15(4) sent 2 and 3 ITA.  
 68. Section 15(4) sent 4 and 5 ITA.  
 69. For example, interest and capital gains on bonds are subject to the same tax rate.  
 70. Section 8(2) CTA. Exceptions only apply in cases of certain unincorporated associations, foundations and other societies within the meaning of s. 1(1) No. 4 to No. 6 CTA.  
 71. Annex, §A5.02[A].  
 72. Section 8b(1), (2) and (4) CTA. For trade tax purposes, non-portfolio dividends are only exempt if the company receiving the dividends holds 15% or more of the share capital (s. 9 No. 2a Trade Tax Act (TTA)). Equity capital gains from the disposal of shares are 95% tax-exempt for trade tax purposes (s. 7 TTA).  
 73. Sections 8b(3) sent 1 CTA (equity capital gains) and 8b(5) sent 1 CTA (dividends).  
 74. Section 8b(3) sent 3 CTA.

level of the shareholding held by the corporate taxpayer.<sup>75</sup> Portfolio dividends were initially 95% tax-exempt for corporate tax purposes.<sup>76</sup>

A recent decision of the ECJ has however forced Germany to either introduce a complete exemption of dividends for both domestic and foreign corporate shareholders, or alternatively, to tax portfolio dividends also in the hands of domestic corporate shareholders.<sup>77</sup>

The German tax legislator has opted for a taxation of portfolio dividends where the shareholding consists of less than 10% of the share capital.<sup>78</sup> Dividends will be in principle subject to an economic double taxation due to taxation at the company level and again at the level of the corporate shareholder. Dividends remain 95% tax-free for corporate tax purposes if the shareholding is 10% or more of the share capital at the beginning of the calendar year.<sup>79</sup>

With regard to derivatives, gains from the disposal of shares received or delivered in the context of physically settled derivatives are 95% tax-free,<sup>80</sup> whereas cash settled derivatives are taxed as ordinary business income.<sup>81</sup>

The distinction between equity and debt also has relevance in relation to the loss ring-fencing provision of section 15(4) sent 3 ITA. The loss ring-fencing provision does not apply if the taxpayer is a bank, credit institution, financial service company or a financial company<sup>82</sup> and if the derivative belongs to the regular course of business of those taxpayers.<sup>83</sup>

In addition, the loss ring-fencing provision does not apply for other taxpayers if the derivative is used to hedge business activities that are 'part of the regular course of the taxpayer's business'.<sup>84</sup> Both carve-outs do not apply, and the derivatives losses are

75. The second legislative chamber (*Bundesrat*) proposed on 7 Nov. 2014 a minimum 10% shareholding for equity capital gains from the disposal of shares to qualify for the 95% participation exemption. See: Deloitte, *Germany Tax Alert: Upper house of parliament proposes new anti-hybrid rule and other measures* (7 Nov. 2014). As of 1 Jan. 2015, the first chamber (*Bundestag*) has not yet introduced that proposal into legislation. See: PWC 'Heimliches Jahressteuergesetz 2015 beschlossen' (2015) <<http://www.pwc.de/de/steuerberatung/das-heimliche-jahressteuergesetz-2015.jhtml>> accessed 13 May 2015.  
 76. Portfolio dividends were and are still subject to German trade tax (s. 8 No. 5 TTA).  
 77. C-284/09 *Commission v. Germany* [2011] ECR I-09879.  
 78. Section 8b(4) sent 1 CTA.  
 79. A shareholding of at least 10% that is acquired during the calendar year is deemed to be acquired at the beginning of the calendar year and thus falls under the dividend exemption of s. 8b(1) CTA.  
 80. The 95% tax exemption for equity capital gains under s. 8b(2) CTA also applies to the subsequent disposal of shares that were delivered under a physically settled equity derivative. The physical settlement of the derivative is treated as a tax neutral acquisition of the underlying shares.  
 81. Johannemann and Herr (2013) D2.03[6].  
 82. Financial companies are those within the meaning of s. 1(3) *Kreditwesengesetz* (German Banking Act).  
 83. Section 15(4) sent 4 1st alt ITA. See Johannemann and Herr (2013) D2.03[6]; Haisch and Helios (2011) 269.  
 84. Sections 8(1) CTA, 15(4) sent 4 2nd alt ITA. For a detailed discussion of the phrase 'part of the regular course of the taxpayer's business', see Annex §A5.02[C][2][a]. See also: Johannemann and Herr (2013) D2.03[6]; also: Haisch and Helios (2011) 270-274.



## §7.02 THE ACCOUNTING AND TAX TREATMENT OF HEDGING RELATIONSHIPS

From the economic proposition of hedging, one has to distinguish the accounting and tax treatment of hedging relationships. Hedging raises two main issues in relation to derivatives which should be distinguished from each other:

- (1) hedge accounting and its tax treatment during the term of a hedging relationship; and
- (2) the treatment of hedging relationships from a post-tax perspective.

### [A] Hedge Accounting and Its Tax Treatment during the Term of the Transaction

The purpose of hedge accounting is to reduce earnings volatility caused by accounting mismatches between the hedged item and the hedging instrument during the term of the hedging relationship.<sup>15</sup> These mismatches may arise if both instruments are accounted on a different accounting basis, leading to the recognition of profits or losses in different accounting periods.

Hedge accounting of derivatives can follow two different approaches. The hedge and the hedged item may be treated as a single 'synthetic' off-balance sheet transaction<sup>16</sup> or valuation unit.<sup>17</sup> Or, the impact of the hedged item may be matched with the hedging instrument in the income statement by recognising profits and losses on both items in the same accounting period.<sup>18</sup>

From a tax perspective, the issue of hedge accounting is primarily one of timing, as profits and losses from the hedge and the hedged item should be matched and taxed in the same accounting period. A tax system needs to provide appropriate (tax) hedging provisions for taxpayers in order to allow tax-neutral and cost-efficient hedging of risks arising in assets and liabilities and other balance sheet items during the term of the transaction.<sup>19</sup> However, tax hedging provisions normally do not provide an answer as to how the hedge and the hedged item are treated for tax purposes at maturity as they only concern the treatment during the term.

15. Southern (2012) paras 16.3–16.5; OECD (2001) para. 121.

16. Under old UK GAAP, the hedge and the hedged item were accounted off-balance sheet. See: HMRC CFM57010; Haworth and Hollis (2010) 28.

17. German accounting rules treat a hedging relationship for accounting purposes as a 'valuation unit' (*Bewertungseinheit*). Compare: IDW (2011a) para. 11.

18. Southern (2012) para. 16.20.

19. See Ch. 3 s. §3.04. Compare: Neighbour (2001) para. 14; OECD (2001) paras 80, 118 and 121.

## [B] Treatment of Hedging Relationships from a Post-tax Perspective

The second question concerns the tax treatment of the hedged item and the hedge on a post-tax basis, i.e., whether gains or losses of the hedge and the hedged item are taxed differently, thus leading to a mismatch in taxation of both items and an incomplete hedge on a post-tax basis.<sup>20</sup>

### Example 32:

Company A holds shares in Company B. Gains on these shares are tax-exempt and losses are non-deductible. Company A hedges its equity position with the purchase of a reverse equity note that provides an exposure opposite to the performance in the shares of Company B. Gains on this note are treated as taxable and losses are treated as tax deductible.

If Company A makes a gain on the shares, this gain will be tax-exempt. At the same time, Company A will make a loss on the note which is tax deductible, leading to a favourable tax position of Company A on a post-tax basis.

Vice versa, if the shares stand at a loss, the loss will be non-deductible, whereas the corresponding gain on the note will be fully taxable. Thus, Company A will have an incomplete hedge on a post-tax basis.<sup>21</sup>

Thus, the question of tax-efficient post-tax hedging is primarily one of tax law as it concerns the question whether gains or losses of the hedged item and the hedge are subject to the same tax treatment, or whether they are treated differently for tax purposes, thus leading to disparities and incomplete hedges on a post-tax basis.<sup>22</sup>

## §7.03 TREATMENT OF HEDGING TRANSACTIONS UNTIL MATURITY IN THE UK AND GERMANY

### [A] Derivatives Hedging Transactions in the UK

#### [1] Treatment of Derivatives Hedging Transactions for Accounting Purposes

Although some companies are still allowed to apply old UK GAAP for derivatives, many companies already account for derivatives under 'new UK GAAP' by applying FRS 26, which is now fully aligned with IAS 39, or account under IAS 39 directly.<sup>23</sup>

20. OECD (2013a) 15.

21. *Ibid.*, 15–17, Table 2a and 2b.

22. This question is closely interlinked with the question of the different tax treatment of equity and debt for tax purposes.

23. See Ch. 6 s. §6.02[B].



as almost all balance sheet positions could be attributed to the macro hedge, allowing macro hedging for tax purposes would open up various tax arbitrage possibilities for deferring otherwise taxable income.

Third, tax systems have to decide whether to apply the hedging provisions of IAS 39, the provisions used in local accounting rules, or whether they design a separate set of hedging rules for tax purposes. The application of the hedge accounting provisions of IAS 39 in the single company accounts leads to significant challenges that the tax legislator has to deal with. When applying IAS 39 in the single company accounts for tax purposes, the tax legislator can either follow IAS 39 with the consequence of very restrictive hedging provisions which may lead to significant P&L volatility tax-wise.

Alternatively, a deviation from the hedging provisions of IAS 39 has to be implemented for tax purposes with the consequence of a separate tax legislation that deals in detail with the criteria that allow hedge accounting for tax purposes.<sup>143</sup>

In my view, tax systems should rather seek to incorporate a different set of hedging rules into their tax laws that provide tax-neutral hedge accounting for micro and portfolio hedging positions instead of applying IAS 39 indiscriminately in the tax legislation as tax rules can be better tailored to serve the purpose of reducing earnings volatility during the term of the transaction for tax purposes.

Further, if the tax legislator adopts the hedging provisions of IAS 39 also in the tax accounts, problems may also arise in the future if a much more generous approach on macro hedging is applied in the course of the introduction of IFRS 9. However, problems may also occur if the local legislator permits all hedging approaches both in the financial and tax accounts, as macro hedging may be used as a means of deferring income by allowing the assets and derivatives to be part of a macro hedging relationship.

Fourth, anti-avoidance provisions may have to be introduced that tackle transactions that use the hedging rules as a means to defer income in the future for tax purposes.

As a solution to manage tax arbitrage risks, tax authorities may limit hedging provisions to apply only to certain types of transactions and only allow certain hedging approaches, such as micro hedging and portfolio hedging.

Additionally, tax legislators may also introduce specific tests to determine whether the hedge is in fact used for risk reduction purposes. In this respect, the criteria of 'hedge effectiveness' may be used as a quasi anti-avoidance measure for tax purposes to determine whether hedging tax provisions can be applied or not.<sup>144</sup>

143. See Ch. 7 s. §7.03[A][2].

144. Alternatively, the legislator may limit the possibility of hedge accounting by an acceptable range in order to avoid tax arbitrage of hedging provisions. In the context of accounting, this approach is favoured by IAS 39, AG 105, which provides that a hedge is only effective for accounting purposes if it remains during the whole time of the hedging relationship in the range between 80% and 125%.

### [B] Solutions in Respect of the Tax Treatment of Hedges on a Post-tax Basis

The question arises whether tax systems should only recognise pre-tax hedges, or whether they should also permit post-tax hedging for tax purposes if hedging strategies are not fully effective on a post-tax basis.<sup>145</sup>

For example, a pre-tax hedge may not provide a full hedge on a post-tax basis if the hedged item and the hedge are treated differently for tax purposes.<sup>146</sup> Hedging rules that only consider the pre-tax position of the taxpayer may lead to taxation results where the taxpayer is left with an incomplete hedge on a post-tax basis.<sup>147</sup> Or, the taxpayer earns tax-free gains on an asset, which are overcompensated by tax deductible losses from the hedge.<sup>148</sup>

On the other hand, in the absence of specific anti-avoidance rules, tax arbitrage strategies could be executed, which allow taxpayers to profit from different taxation treatment of the hedged item and the respective hedge. Nonetheless, hedges that are partly ineffective on a post-tax basis deliver a significant argument that can be brought forward against a policy approach that only allows the hedge to be efficient on a pre-tax basis but does not provide hedge neutrality on a post-tax basis.<sup>149</sup>

In my view, tax legislators have to consider several factors in order to draft the (tax) hedging rules carefully in a way that neither deter businesses from hedging their risk positions due to ineffective post-tax hedges or increased hedging costs because of the need to overhedge, nor provide too much room for unwanted risk shifting schemes that move certain market risks of transactions from the taxpayer to the Revenue.

First, a tax legislator should consider general mismatches in the taxation of different items of income, financial assets and liabilities and abolish these mismatches as far as possible.

Second, the tax legislator should investigate whether the tax legislation applying to hedging relationships is potentially prone to unwanted tax arbitrage in the form of overhedging or underhedging schemes.

Third, if a potential for tax arbitrage due to taxing mismatches or the hedging rules has been identified, tax systems should consider how they want to deal with tax arbitrage schemes that utilise the differences in taxation between the hedged items and the hedge and potentially introduce targeted anti-avoidance legislation.

Fourth, if the legislator wants to design a competitive tax system that aims at lower hedging costs for taxpayers and abolish any obstacles that hinder efficient

145. OECD (2013a) 15.

146. Neighbour (2001) 5, explains the negative outcome of a pre-tax hedge at the example of a currency forward, where the tax authorities may tax an FX gain although the taxpayer has incurred a net FX loss.

147. This is the case if arising losses from the hedged asset are non-deductible (e.g., equity losses), whereas corresponding gains on the hedge are fully taxable.

148. The outcome will depend on the price movements in the underlying asset and correspondingly the price movements in the hedging instrument.

149. Similar: Neighbour (2001) 8.



under CTA 2009, Part 7 in relation to the embedded derivative(s).<sup>77</sup> A bifurcation for tax purposes under CTA 2009, sections 584–586 will apply to the following structured products and hybrid instruments under the following circumstances:

- (a) hybrid derivatives with embedded derivatives under CTA 2009, section 584, in cases where the hybrid derivative is bifurcated and not treated as one derivative for accounting purposes;<sup>78</sup>
  - (b) loan relationships with embedded derivatives under CTA 2009, section 585, if the company bifurcates the structured product or hybrid instrument for accounting purposes under new UK GAAP or IFRS;
  - (c) loan relationships with embedded derivatives under CTA 2009, section 585, where the company does not bifurcate the instrument for accounting purposes because it applies old GAAP, but it would be required to bifurcate for accounting purposes under new UK GAAP or IFRS under the same circumstances *and* the company has elected that it will be treated for tax purposes as bifurcating the asset;<sup>79</sup>
  - (d) other contracts, neither being loan relationships nor hybrid derivatives, with embedded derivatives, if the company treats these contracts as bifurcated for accounting purposes, and the company has elected back into the taxation in accordance with the accounts under CTA 2009, section 617(1).<sup>80</sup> The general rule for these contracts is however, that the bifurcation is reversed for tax purposes and the company is treated for tax purposes as though the combined other contract with an embedded derivative had not been bifurcated.<sup>81</sup>
- (4) If bifurcation occurs, gains or losses of the bifurcated embedded derivative will in principle be realised on a fair value basis. In case of convertible and exchangeable bonds or asset-linked debt, the holder of the debt will however treat these gains and losses that are attributed to the embedded derivative contract as capital gains for tax purposes under the derivative contracts regime of CTA 2009, Part 7 Ch 7 and 8.<sup>82</sup>
- (5) CTA 2009, sections 584–586 applies also to issuers of structured products and hybrid instruments, as these sections determine in which cases these financial instruments are bifurcated for tax purposes. From an issuer's perspective, the part bifurcated from the host contract will either be treated as equity or as an embedded derivative contract.<sup>83</sup> If the residual embedded element is treated as an equity instrument, no revaluations will take place;<sup>84</sup> if it is treated as an

77. Haworth and Hollis (2010) 25.

78. Ghosh, Johnson and Miller (2013) [E9.142]-[E9.143].

79. CTA 2009, ss 416, 417; See: Southern (2012) para. 15.25.

80. CTA 2009, s. 586(2), but subject to the exception of CTA 2009, ss 586(4), 616.

81. CTA 2009, ss 616(4) and (5). See: Ghosh, Johnson and Miller (2013) [E9.145].

82. Haworth and Hollis (2010) 29; Southern (2012) para. 15.27.

83. Southern (2012) para. 15.27.

84. HMRC CFM55510 suggests that 'the embedded obligation to convert debt into its own shares will generally be a "tax nothing", giving rise to no taxable debits or credits under either an income or chargeable gains code'. See also: Southern (2012) para. 15.27.

embedded derivative, it will be accounted for on a fair value basis, but 'the annual fair value movements are ignored for tax purposes'.<sup>85</sup>

## §8.06 BIFURCATION VERSUS INTEGRATION APPROACHES IN GERMANY

### [A] Accounting of Structured Products and Hybrid Instruments under German GAAP

German GAAP<sup>86</sup> does not contain specific rules regarding the accounting of structured products.<sup>87</sup> The only exception is section 272(2) No. 2 CLA that requires the bifurcation of convertible bonds and bonds cum warrants from the perspective of the issuer of the bond.<sup>88</sup> The general accounting principles, including the principles of orderly accounting, will also apply for structured products and hybrid instruments, including that every asset or liability has to be accounted for by observing the item-per-item valuation principle both in the financial and tax accounts.<sup>89</sup> Thus, in principle every asset or liability should be accounted for and valued in its entirety.<sup>90</sup>

#### [1] *Bifurcation versus Integration for Structured Products under German GAAP (IDW View)*

With regard to the accounting of structured products, the IDW (Institute of Public Auditors) has issued a statement in 2008.<sup>91</sup> IDW statements are not part of German GAAP, but they can be used when interpreting the German accounting principles<sup>92</sup> and the auditor has to verify whether the statements are applicable and has to give reasons

85. Southern (2012) para. 15.27; Haworth and Hollis (2010) 29. Compare: CTA 2009, Part 7, Ch. 8, ss 651–655.

86. See Chapter 6, s. §6.03[A].

87. Scharpf and Schaber (2009) 236. Also: Olaf Maulshagen, Folker Trepte and Sven Walterscheid, *Derivative Finanzinstrumente in Industrieunternehmen* (4th edn, Fachverlag Moderne Wirtschaft 2008) 244; Tristian Nguyen, *Bilanzielle Abbildung von Finanzderivaten und Sicherungsgeschäften* (1st edn, Herbert Utz Verlag 2007) 76.

88. Johannemann and Herr (2013) D2.03[4]; Nguyen (2007) 76; Scharpf and Schaber (2009) 243; Schmitz and Huthmann (2012) 132.

89. Sections 246(1), 252(1) No. 3 CLA. See: Johannemann and Herr (2013) D2.03[4]; Scharpf and Schaber (2009) 236; Schmitz and Huthmann (2012) 132.

90. Scharpf and Schaber (2009) 236.

91. IDW, RS HFA 22, *Zur einheitlichen und getrennten handelsrechtlichen Bilanzierung strukturierter Finanzinstrumente* (2 Sep. 2008) WPg Supplement 4/2008, 41ff, FN-IDW 10/2008, 455ff. The new statement substitutes the old statement of IDW, *RH BFA 1.003, Rechnungslegungshinweis: Zur Bilanzierung strukturierter Produkte* (2001) WPg 2001 916 which was authoritative only for audits of financial institutions. The new statement by the IDW is applicable to all audits of persons, partnerships and corporate entities that engage in a trade and account under s. 4(1), 5(1) CLA, independently of their legal form and the industry sector of their trade activities. See: IDW (2008) para. 1.

92. In contrast, International Standards of Auditing (ISA) will be directly applicable and binding for auditors when they will be adopted by the respective Member State of the EU.



**[A] Withholding Taxes on Derivatives in the UK**

A company is not required to withhold tax on payments made by it under any derivative contract if that contract falls within the derivative contracts regime of CTA 2009, Part 7.<sup>2</sup>

*Example 49:*

Company A enters into a single stock future over UK shares, which is traded on a UK stock exchange. As the future is a relevant contract that satisfies the accounting tests and its underlying is not an excluded subject matter, it will qualify as a derivative contract under CTA 2009, Part 7 and thus will be explicitly excluded from the withholding tax regimes under ITA 2007, section 980(1).

Payments on derivatives which fall outside the regime of Part 7 may potentially be caught by other withholding tax provisions, for example derivatives that do not fulfil the accounting test or derivative contracts on excluded underlyings.<sup>3</sup> ITA 2007, Part 15 applies to both individuals and companies<sup>4</sup> and provides rules for withholding taxes on annual interest,<sup>5</sup> annual payments,<sup>6</sup> manufactured payments and payments to non-resident landlords.<sup>7</sup> However, in many cases withholding taxes will not be levied, as the payments under these contracts may not fit under the definitions of ITA 2007, Part 15.

*Example 50:*

Company A enters into an interest rate swap with Company B. The contract falls outside CTA 2009, Part 7, for example, because the accounting tests under CTA 2009, section 579 are not satisfied. The swap would not be subject to the withholding tax rules on interest, as these payments would not qualify as yearly interest within the meaning of ITA 2007, section 874(1). Payments under interest rate swaps are reciprocal obligations under swap contracts,<sup>8</sup> and thus, they would generally not constitute a pure income profit by the recipient, which would be an implicit condition for the qualification as annual payments.<sup>9</sup>

2. ITA 2007, s. 980(1) and (2). See: HMRC CFM13608; Ghosh, Johnson and Miller (2010) [E.2.541].  
3. Ghosh, Johnson and Miller (2010) [E.2.543].  
4. HMRC, *Proposed changes to tax rules on manufactured payments, Consultation document* (27 Mar. 2012) para. 2.15.  
5. ITA 2007, s. 874.  
6. ITA 2007, Part 15, Ch. 6. Types of payments are, for example, life annuity payments and royalties (ITA 2009, s. 899).  
7. ITA 2007, Part 15, Ch. 9.  
8. Ghosh, Johnson and Miller (2010) [E.2.545].  
9. HMRC CFM50080.

**[B] Withholding Taxes on Derivatives in Germany**

In the context of withholding taxes on investment income, German tax rules distinguish between resident companies and foreign corporate investors. Domestic companies in principle pay withholding taxes on investment income.<sup>10</sup> This withholding tax payment can however be credited against the corporate tax liability.<sup>11</sup> Any excess tax will be refunded.<sup>12</sup> With regard to certain investment income, such as income from foreign dividends,<sup>13</sup> received option premiums,<sup>14</sup> derivatives income,<sup>15</sup> and income from most structured products,<sup>16</sup> no withholding tax will be levied if the income is received by a domestic company.<sup>17</sup> No withholding tax is levied on capital gains received by companies from the sale of shares.<sup>18</sup>

Withholding tax is however due on income from convertible bonds<sup>19</sup> as well as on domestic dividends.<sup>20</sup>

Non-resident corporate investors are only liable to withholding tax on investment income, if:

- (1) the investor falls under the source taxation rules (limited tax liability) under section 49(1) ITA; and
- (2) the payments are subject to the withholding tax regime under section 43ff ITA.<sup>21</sup>

Derivatives, like options, swaps, forwards and futures entered into by foreign investors with German counterparties, as well as received option premiums, will normally not be subject to withholding taxes as they generally do not fall under the catalogue provided in the source taxation rules of section 49(1) ITA.<sup>22</sup>

Although payments would principally be subject to withholding taxes if the derivative contract is entered into by a permanent establishment (PE) of a company and held in the PE's business assets,<sup>23</sup> section 43(2) sent 3 No. 2 ITA provides for an exemption from withholding taxes with regard to derivatives payments and certain

10. Sections 43(1), (4) and (5) sent 2 ITA, 8(1) CTA.  
11. Sections 36(2) No. 2 ITA. See: Johannemann and Herr (2013) D2.04[2][b]; Klaus Lindberg, '§ 43 EStG' in Bernd Heuermann and Peter Brandis (eds), *Blümich, EStG, KStG, GewStG, Kommentar* (120 edn, 2013) § 43, para. 127.  
12. Section 36(4) sent 2 ITA. See: Johannemann and Herr (2013) D2.04[2][b]; Ronald Ettlich, '§ 36 EStG' in Bernd Heuermann and Peter Brandis (eds), *Blümich, EStG, KStG GewStG Kommentar* (120 edn, 2013) § 36, para. 246.  
13. Sections 43(2) sent 3 No 1, 43(1) No 6 ITA.  
14. Sections 43(2) sent 3 No 1, 43(1) No 8, 20(1) No 11 ITA.  
15. Sections 43(2) sent 3 No. 1, 43(1) No 11 ITA.  
16. Sections 43(2) sent 3 No. 1, 43(1) No. 10 ITA.  
17. Sections 43(2) sent 3 No. 1 ITA.  
18. Sections 43(2) sent 3 No. 1, 43(1) No. 9 ITA.  
19. Section 43(1) No. 2 ITA.  
20. Section 43(1) No. 1 ITA.  
21. Johannemann and Herr (2013) D2.04[2][c].  
22. Thomas Wiesenbart, 'Internationale Steuerfragen bei derivativen Finanzinstrumenten' *Recht der Finanzinstrumente* (2011) 106, 112–114; also: Johannemann and Herr (2013) D2.04[2][c].  
23. Section 49(1) No. 2a) ITA.



interest rate (LIBOR)<sup>114</sup> plus a margin.<sup>115</sup> It should be noted that the swaps had a minimum holding period of three months (average six months), and that a single swap was concluded over different equities traded on the Swiss stock exchange (the 'equity baskets').<sup>116</sup>

The Swiss shares hedging the swaps provided Danish Bank with the dividends, which it had to pass on under the swaps. They were purchased shortly before the dividend date and were sold after the dividend due dates in OTC transactions via international brokers.<sup>117</sup>

Under Swiss law, a 35% withholding tax is levied at source on the dividends received from Swiss equities. Danish Bank claimed a refund of the 35% withholding tax levied on the dividends under Article 26(2) of the Switzerland/Denmark treaty<sup>118</sup> as the treaty reduced the withholding tax rate to zero and allowed a reclaim of these withholding taxes.<sup>119</sup> No withholding tax was due on the payments under the swaps.<sup>120</sup>

The Swiss tax authorities denied the tax refund. They concluded that Danish Bank was not the beneficial owner of the dividends because it had passed on the market risk to the counterparties of the swaps. The Swiss tax authorities also argued that the transactions should be regarded as treaty abuse<sup>121</sup> on the basis that the combined transactions were highly unusual in size and structure and only motivated by purely fiscal considerations.<sup>122</sup> However, the Swiss Federal Administrative Court applied a narrow interpretation of the term 'beneficial owner'<sup>123</sup> and decided that Danish Bank was the beneficial owner of the dividends because:

[r]egardless of whether it received the dividends, the complainant was obliged to pay the counterparty the amounts equivalent to the dividends. At the same time, the complainant was free to decide, independently of the swap contracts, whether to buy the shares in question and to receive the corresponding dividends.<sup>124</sup>

114. The LIBOR rate paid to the short party represents the amount of interest that the short party will pay to a third-party lender for the cash it needs to purchase the underlying shares physically in order to be fully hedged. It is assumed here, that Danish Bank will be able to finance itself at LIBOR flat.

115. A-6537/2010 (2012) 14 ITLR 638, 693, para. 6.1.

116. *Ibid.*, para. 6.1.

117. *Ibid.*, paras 1. and 6.1.

118. Abkommen der Schweizerischen Eidgenossenschaft und dem Königreich Dänemark zur Vermeidung der Doppelbesteuerung auf dem Gebiete der Steuern vom Einkommen und vom Vermögen (1973).

119. Article 26(2) in conjunction with Art. 10(1) Switzerland/Denmark treaty. See: A-6537/2010 (2012) 14 ITLR 638, 685, para. 3.1.

120. Desax and Busenhardt (2012) 557. Art 10 of the treaty was amended on 22 Nov. 2010 by a protocol and now provides a general right of the source state to levy 15% withholding tax on dividends (new Art. 10(2) of the treaty).

121. No general anti-abuse clause was contained in the Switzerland/Denmark treaty of 1973.

122. A-6537/2010 (2012) 14 ITLR 638, 674, para 1.

123. Although the Switzerland/Denmark treaty (1973) does not contain an explicit reference to the term 'beneficial owner' as the treaty was concluded before introduction of the beneficial ownership - concept in Art. 10(2) of the OECD Model (1977), it is thought that the criterion of beneficial ownership is implicitly contained also in double taxation conventions concluded before that date. See: A-6537/2010 (2012) 14 ITLR 638, 687-688, paras 3.3.1. and 3.3.2.

124. *Ibid.*, para. 6.2.1.

On the second ground, the court decided that there was no treaty abuse.<sup>125</sup> With regard to this question, the court only questioned whether the Danish Bank had a seat in Denmark and engaged in genuine commercial activity. As this was the case, it did not investigate further the question of abuse as it deemed a general commercial activity of the Danish Bank as sufficient to deny treaty abuse.<sup>126</sup>

The Swiss court further considered whether there was a link between the purchase and the sale of the shares and the swap agreements and denied that link and assumed no interdependence of both transactions.<sup>127</sup> The purchase and the sale of the shares were conducted in OTC transactions with international brokers.<sup>128</sup> The Danish Bank provided a notary certificate, that the parties of the swaps are not the same parties as the seller of the shares.<sup>129</sup>

#### (ii) Evaluation of the *Swiss Swaps Case*

In my view, the Swiss court's decision has shown the general difficulties in applying the concept of 'beneficial ownership' in transactions where derivatives are used to transfer risks and rewards of the underlying asset to the counterparty.

I agree that it might have been the case, that the sale and the purchase of the shares was conducted via a broker who was simply standing in between both counterparties and who acted as an independent counterparty for both parties although the Danish Bank may not have directly purchased the shares from the swap counterparties.<sup>130</sup> This is however a question of fact, which was not further investigated by the Swiss court, and thus cannot be the basis for a legal evaluation of the case.

From a pure legal perspective, the case shows that the concept of 'beneficial ownership' can be interpreted widely to encompass an anti-abuse element, or narrowly by regarding the concept as distinct from any question of abuse of legal rights. The narrow interpretation of the term 'beneficial owner' was adopted by the Swiss Federal Administrative Court:

Seen in its proper perspective, however, the concept of beneficial ownership is merely a condition of entitlement like, say, the concept of residence, rather than a singular abuse clause [...] Only once all the conditions of entitlement under a DTC are met (including beneficial ownership) does the question of potential abuse of the convention arise. This outcome accords with Federal Supreme Court practice, which draws a clear distinction between the concept of beneficial ownership and abuse of legal rights.<sup>131</sup>

125. *Ibid.*, para. 7.2.

126. *Ibid.*, para. 7.2.

127. *Ibid.*, paras 3.4.2 and 6.2.1.

128. *Ibid.*, para. 6.1.

129. A-6537/2010 (2012) 14 ITLR 638, 677, para K.

130. Rene Matteotti, 'Beneficial Ownership Switzerland' (Beneficial Ownership conference, Vienna, 18-19 May 2012) Slides 10-12, who questioned whether there was an interdependence due to the fact that the Danish Bank used a broker to buy and sell the shares.

131. A-6537/2010 (2012) 14 ITLR 638, 690, para. 3.4.3.



- (2) the application of a special taxation regime versus applying the general taxation rules when taxing derivatives, and the influence of the distinction between income and capital, and between equity and debt on the taxation of derivatives;
- (3) the question of alignment of accounting standards and taxation rules and the application of fair value accounting when taxing derivatives;
- (4) tax-efficient hedging, the application of different hedging approaches and hedge accounting rules for tax purposes and the taxation of post-tax hedging transactions;
- (5) bifurcation or integration of structured products and hybrid instruments for tax purposes;
- (6) the application of withholding taxes to derivatives, the problem of dividend stripping transactions that utilise derivatives and the beneficial ownership concept in relation to derivatives transactions;
- (7) tax arbitrage schemes and derivatives, the problem of tax arbitrage and loopholes in the general design of the tax system and the effectiveness of specific anti-avoidance measures, disclosure rules and GAARs applying to derivatives.

### §11.03 SUMMARY OF SOLUTIONS ADOPTED BY THE UK AND GERMANY AND MY PROPOSED SOLUTIONS REGARDING THE TAXATION PROBLEMS POSED BY DERIVATIVES

Tax legislators have to act at various levels in order to tackle the problems posed by derivatives comprehensively and successfully.

First, the domestic tax legislator has to deal coherently with the taxation issues arising in the context of domestic derivatives transactions.

Second, national legislation has to deal with the taxation problems that arise if derivatives are used in cross-border transactions.

Third, solutions for the taxation of cross-border derivatives transactions have to be found, either in the context of bilateral tax treaties, or at a multilateral level in the context of the OECD and UN.

From a tax policy perspective, coherent taxation rules on derivatives should ensure an uninhibited access to the derivatives markets for taxpayers, promote a level playing field for all market participants, and at the same time prevent loopholes in the tax system that encourage taxpayers to enter into tax arbitrage schemes.

#### [A] Problem 1 and Its Solution

##### [1] Definitions of Derivatives in the UK and German Tax Legislation

The UK has adopted an advanced approach when defining derivatives for corporate tax purposes by implementing a three-step test in the tax legislation to determine if an

instrument qualifies as a 'derivative contract'.<sup>1</sup> Nevertheless, the existing definition under CTA 2009, Part 7 may however not cater for all newly emerging derivatives as the types of derivatives and the underlyings are only dealt with by way of enumeration instead of defining the scope of the term 'derivative contract' with the help of abstract definitional criteria.

The second weakness of the definition contained in CTA 2009, Part 7 is the definitional method that allows to define the term by way of exceptions and counter-exceptions entailed in the 'accounting test' and the 'excluded underlying test' to narrow down the scope of the definition. Thus, no clear concept arises as to what constitutes a derivative contract for tax purposes.

Although problems with the definition of derivative contracts under CTA 2009, Part 7 exist, the UK legislator has nonetheless adopted a far more sophisticated approach in defining derivatives for tax purposes compared to the German legislator.

The German tax legislator simply uses the term 'derivative contract' (*Termingeschäft*) in the Income Tax Act applying to individuals and businesses<sup>2</sup> without defining the term in the tax legislation itself.<sup>3</sup> This approach has created significant uncertainty in respect to the scope of the term 'derivative contract' as it is unclear whether the term has the same meaning as in capital markets law, or whether it has an independent meaning for tax purposes.

In particular, it remains open to interpretation whether losses from physically settled derivatives will be subject to the loss ring-fencing rule applying to business and corporate taxpayers, or not.<sup>4</sup> Therefore, it is imperative from a systematic point of view that derivatives are defined comprehensively in the tax legislation in order to allow a determination of the exact scope of the term for taxpayers and the Revenue alike.

#### [2] Solution to Problem 1: Abstract Definition of Derivatives in Tax Legislation

An abstract and comprehensive definition of derivatives in the national tax legislation would allow the capture of newly developed derivatives without an adjustment of existing tax legislation to new instruments and therefore would help tax legislators to respond more quickly to tax arbitrage strategies that utilise derivatives. I have therefore proposed the following abstract definition for tax purposes in Chapter 4 section §4.06[B][5]:

*A financial instrument qualifies as a derivative if (and as long as):*

1. its value depends on the value of one or more independent underlying variables,
2. its payoff is deterministically dependent on stochastic variables, i.e., the payoff depends in an uncertain way on the value of the underlying variable, but the payoff function as such is pre-defined,

1. See Ch. 4 s. §4.03[A][2][a] to §4.03[A][2][c].

2. The section concerning business investors is referred to in the corporate tax legislation.

3. See Ch. 4 s. §4.03[B][1] and §4.03[B][2].

4. See Ch. §4.03[B][2].



The function of the third layer (recovery rate) can be illustrated by the following example:

*Example 67:*

Company A purchases a CDS from Bank B in order to protect against a default of Company C. The CDS is referenced to the corporate bond X (term until maturity five years), which was issued by Company C. The CDS has a term of two years. Company C goes bankrupt in year 1. The default under the CDS is triggered by the credit event 'bankruptcy' of Company C. As Company C will not repay its obligation under the bond, Company C defaults on the reference bond under the CDS.

An auction is held after default of Company C in order to determine the recovery value of the corporate bond. In the auction, the bonds are sold with 40% of their notional value, thus the recovery rate is determined at 40% of the notional value of the bond. Bank B will pay Company A 60% of the notional value of the bond X under the CDS (1%–40%).

CDSs and other credit derivatives only qualify as derivatives for tax purposes under the proposed definition if they can be replicated using other derivatives, the underlying asset or other financial instruments.<sup>22</sup> Because a CDS is always referenced to a specific bond, the protection seller can replicate the assumed risk under the CDS by shorting the underlying reference bond.

*Example 68:*

Bank A sells protection in respect of the default of Company C to Company B under a CDS. The CDS pays out the notional value 100 minus the recovery rate, if Company C defaults on the reference bond X. The term of the CDS is two years, and Company B pays periodic interest payments to Bank A for the default protection under the CDS.

Bank A borrows the reference bond from Bank D and sells the bond to Bank E in order to hedge its exposure under the CDS. If Company C defaults under the reference bond X, assuming a recovery rate of, for example, 20% in the auction, Bank A has the following position:

- (1) Bank A pays to Company B 100%–20% which equals 80% of the notional value of the reference bond.
- (2) Bank A makes a gain of 80% of the notional value of the reference bond under the short position because it has sold a bond for 100 to Bank E. When returning the borrowed reference bond to Bank D, it simply purchases the bond at 20% of the notional value in the market because that is the value the

22. See Ch. 4 s. §4.06[B][4].

*bond has after default and closes its short position, thereby making a gain of 80% of the notional value of the bond.*

- (3) *The gain under the short position offsets the loss under the CDS.*

Hence, by entering into the short position Bank A could perfectly hedge the risk of payment under the CDS.

Thus, because of the possibility to replicate the CDS, and hence hedge the risk position, a CDS referenced to an underlying bond qualifies as a derivative for the purposes of the definition of these instruments for tax purposes.

As CDSs are OTC contracts, the parties could also agree the terms of a CDS which is not referenced to a specific bond, but where the 'reference asset' is a loan or a guarantee. In those cases, a CDS would not qualify as a derivative for the purposes of the tax definition as the protection seller could not hedge against the payment risk under the CDS. For loans or guarantees, no primary or secondary market exists on which the loan or guarantee can be traded during the term of the CDS. Thus, no financial instrument including the reference asset exists that is fungible and liquid, and thus, could be used to replicate the CDS.

Hence, CDSs over loans or guarantees would not qualify as derivatives under the proposed tax definition because a replication or hedge of the CDS would not be possible. Instead, such CDSs over loans or guarantees would qualify as mere bets.

Other credit derivatives include *Credit-Linked Notes* (CLN), Total Return Swaps and Credit Spread Options.

Under a CLN,<sup>23</sup> the buyer of the CLN pays the notional amount of the CLN to the issuer at inception and receives periodic interest payments which consist of interest payments on the capital invested and additional interest for the credit risk that the buyer of the CLN has assumed.

At maturity of the note, the issuer only pays back the notional value of the CLN if no credit event has occurred in the underlying reference asset(s) of the CLN.<sup>24</sup> Underlying reference assets of CLNs could be a specific loan issued by the seller of the CLN to a third party, a single reference bond or a whole portfolio of reference bonds or loans.<sup>25</sup>

CLNs are structured products,<sup>26</sup> as they consist of a bond plus short CDS(s).<sup>27</sup> Before the credit crisis, CLNs were popular instruments under which banks would pool

23. A credit linked note can be regarded as a securitised CDS.

24. Hohl/ Liebig in: Roland Eller, Walter Gruber and Markus Reif, *Kreditrisikomodelle und Kreditderivate* (1999) 508.

25. Scharpf and Luz (2000) 183.

26. See Ch. 8 s. §8.01. Similar: Moorad Choudhry, *An Introduction to Bond Markets* (3 edn, John Wiley & Sons 2006) 315.

27. The investor of the CLN holds a bond and at the same time enters into the position of the protection seller under a CDS. Hence, the payout under the CLN at maturity is the notional value of the bond minus any losses assumed under the position of the CDS on the reference basket of assets. If the basket of underlying reference assets is only worth 50% of the initial value of day 1, the CLN would pay notional value of the CLN -50% of value of the reference basket at maturity.



certain tangible movable property and certain embedded derivatives over shares,<sup>135</sup> a regime was introduced by FA 2002, Sch 26, paragraph 45A-45KA, now CTA 2009, Part 7, Ch 7 and 8,<sup>136</sup> which subjects those derivative contracts to chargeable gains or allowable losses instead of taxing them as income profits or losses.<sup>137</sup>

If the underlying of a derivative consists of land or tangible movable property, CTA 2009, sections 641, 643 and 644 treats any gains or losses on the contract as chargeable gains or allowable losses for corporation tax purposes,<sup>138</sup> provided that the contract is not entered for the purpose of a trade and the company is not an excluded body.<sup>139</sup>

*Example 78:*

Company A purchases a cash settled call option over a selected portfolio of commercial properties for non-trading purposes. The term of the option is two years. The value of the portfolio at inception of the option is GBP 100 million. Company A pays an option premium of, say, GBP 5 million. The strike of the option is set at 100% of the value of the portfolio.

If the price of the commercial property would rise 10% over the two years, company A would make a gain of GBP 5 million (GBP 110 million – strike price – option premium paid). If the price of the property portfolio would not rise over the term of the option, company A would make a loss of GBP 5 million which equals the option premium paid.<sup>140</sup> For tax purposes, the cash settled call option is treated as a CFD and the profits or losses will be subject to tax as chargeable gains or allowable losses under CTA 2009, section 641.

The capital gains tax treatment may also apply to gains or losses on property-based total return swaps which are brought into account under CTA 2009, section 641.<sup>141</sup> Under CTA 2009, section 650, gains or losses on a swap over a property index may be subject to a capital gains treatment within the derivative contracts rules if they

135. Although embedded derivatives over shares are covered by this special regime of CTA 2009, Part 7, Ch. 7 and 8, they will be discussed separately in Ch. 8 of this work in the context of bifurcation.

136. See: SI2004/2001, SI2004/3270, SI2005/646, SI2005/2082, SI2005/3440 and SI2006/3270, on which the introduction of the chargeable gains regime for equity derivatives and derivatives over land was based.

137. Ghosh, Johnson and Miller (2010) [E9.21].

138. Simon's Taxes, vol 5 (2012) D1.884.

139. CTA 2009, s. 643(3) and (4).

An excluded body is defined in CTA 2009, s. 706. They are, for example, open-ended investment companies or venture capital trusts.

140. Note that the loss company A can make will never be more than GBP 5 million, because company A has purchased an option, not a swap or future.

141. For an example of segregation of property-related amount and interest-related amount: HMRC CFM55120.

belong to the property element of the contract.<sup>142</sup> The aim of CTA 2009, section 650 is to segregate property-related amounts from interest-related amounts.<sup>143</sup>

In order to avoid the conversion of capital losses into income losses between connected parties,<sup>144</sup> CTA 2009, section 650 (as amended by FA 2013) does not apply among connected persons.<sup>145</sup> In addition, a tax avoidance 'mini-clause' was added which ensures that CTA 2009, section 650 only applies if 'the securing of a tax advantage is neither the main purpose, nor one of the main purposes, for which the company is a party to the derivative contract'.<sup>146</sup> 'If section 650 does not apply, it merely means that the debits and credits are brought into account as income rather than capital'.<sup>147</sup>

[vi] Taxation of Plain Vanilla Equity Options or Futures

Physically settled plain vanilla equity options or futures, which are not embedded into another financial instrument,<sup>148</sup> fall under the normal provisions of CTA 2009, Part 7 and are not subject to the capital gains treatment of CTA 2009, Part 7 Ch 7 or 8.<sup>149</sup> Instead, any profits or losses are taxed as derivatives income under CTA 2009, section 574.

Any subsequent sales of the shares received due to the exercise of the options or the futures will however be subject to capital gains treatment under TCGA 1992.<sup>150</sup>

One should note that the base cost of the shares<sup>151</sup> has to be adjusted in case of an acquisition of shares through an option exercise or through a futures contract in order to reflect any gain or loss on the option or future, which has already been taxed under the derivative contracts rules.<sup>152</sup> In order to avoid double-counting of gains or

142. Ghosh, Johnson and Miller (2013) [E9.78].

143. HMRC CFM55110.

144. Ghosh, Johnson and Miller (2013) [U1.39] (Issue 9, December 2013).

145. CTA 2009, s. 650(8) as introduced by FA 2013, s. 41 (3)(b).

146. CTA 2009, s. 650(9) as introduced by FA 2013, s. 41 (3)(b).

147. Ghosh, Johnson and Miller (2013) [U1.41] (Issue 9, December 2013).

148. CTA 2009, s. 708 defines a plain vanilla derivative contract as a contract, which is not embedded into another contract. In case of embedded derivatives, most derivatives will be embedded into loan relationship contracts. There are however cases where a derivative contract is embedded into a non-loan-relationship contract, such as sale and repurchase agreements. See: Bramwell and others (2010) H1.4.27; Ghosh, Johnson and Miller (2010) [E9.133].

149. Share-based derivative contracts were previously excluded from the derivative contracts regime but were included into Sch 26 from 16 Mar. 2005 onwards, unless certain conditions as set out in CTA 2009, s. 591 were satisfied. The rules were further redrafted in 2008 to include also equity derivative contracts that produce an interest-like return into the derivative contracts regime. See: HMRC CFM13108, CFM50730 and CFM50740; Ghosh, Johnson and Miller (2010) [E9.111].

150. TCGA 1992 will only apply if the shares are not held on trading account. See: Ghosh, Johnson and Miller (2010) [E9.111].

151. For the purposes of calculating the base cost in accordance with TCGA 1992, s. 38.

152. Bramwell and others (2010) H3.4.1.



convertible is a combined price of a straight bond plus an equity option but uses a calculation based on probabilities of conversion.<sup>2</sup>

#### §A8.02 BIFURCATION OF STRUCTURED PRODUCTS AND HYBRID INSTRUMENTS UNDER IAS 39, IAS 32 AND IFRS 9

##### [A] Definition Criteria under IAS 39, Paragraph 11 as an Indicator for Bifurcation

Under IAS 39, paragraph 11, bifurcation of the embedded derivative from the host contract is only permitted if:

- the economic characteristics and risk of the embedded derivative and the host contract are *not closely related*;
- the embedded derivative, *if it were a stand-alone derivative* would meet the definition of a derivative in IAS 39, paragraph 9; and
- the combined instrument is *not already itself measured at fair value* with any changes in the fair value recognised in the income statement.<sup>3</sup>

The term 'not closely related' is not defined in IAS 39.<sup>4</sup> Instead, only examples are given by the standard that show what closely related means.<sup>5</sup>

##### Example 81:

Equity-linked or commodity-linked interest or principal payments are never closely related to a debt host contract, and thus separation would be required in cases where interest or principal payments are dependent on equity or commodity prices.<sup>6</sup>

Whereas some examples as the one above are easy to put into the category 'not closely related', others are more difficult to categorise.

##### Example 82:

When the payments of the contract are related to the credit risk of the issuer of the debt instrument itself, the feature will be regarded as closely related and no separation of the credit feature is allowed.

- Wilmott (2000) 473 notes that from a pricing and hedging perspective, convertible bonds are highly complex instruments.
- Bramwell and others (2010) H1.2.3; Southern (2012) para. 15.6.
- Southern (2012) para. 15.8.
- IAS 39 (2009) AG30 and AG33. See: Southern (2012) para. 15.8.
- IAS 39 (2009) AG30 (d) and (e). See: Southern (2012) para. 15.10, Example 15.1.

In contrast, where the payments depend on the credit risk of a reference asset other than the debt instrument itself, a separation will be required.<sup>7</sup>

Again other examples of bifurcation of an embedded derivatives component from a host contract do not mirror the economic reality of these instruments.

##### Example 83:

In the case of inflation-linked bonds, both the coupon and the notional are indexed to an inflation index. The holder of the bond not only receives less interest, but also protection against rising inflation by way of indexation of the coupons and the notional to an inflation index.

IAS 39, AG33(f) seems to suggest that no separation is required if the inflation index is one that is commonly used for this purpose in the economic environment in which the debt is denominated, and that separation would be required if the inflation index relates to a different economic environment or the index is not one that is commonly used for this purpose.<sup>8</sup>

Under IAS 39, paragraph 11 the embedded derivative if it were a stand-alone derivative with the same terms as the embedded derivative, would be considered as meeting the definition of a derivative in IAS 39.<sup>9</sup> In my view, the second criterion in IAS 39, paragraph 11 has to be analysed more rigorously.<sup>10</sup>

In the above example, the indexation component would not fulfil the criteria of IAS 39, paragraph 11(b) because the indexation is not achieved by any embedded derivative contract.<sup>11</sup> Thus, the example in IAS 39, AG33(f) cannot be considered as a proper example of an embedded derivative contract as the indexation feature would not meet the definition of a derivative under IAS 39, paragraph 9 if it were a similar stand-alone instrument.

Furthermore, because the definition in IAS 39 is at the same time very wide and too narrow, it (1) *includes* financial instruments that *would not qualify* as derivatives from an economic perspective, and (2) *excludes* certain derivatives that *would qualify* as derivatives from an economic perspective. As a consequence, some instruments

- IAS 39 (2009) AG30 (h). See: KPMG, *Financial Instruments Accounting* (2004) 25, Table 3.2 (on file with the author).
- KPMG (2004) 25, Table 3.2.
- Southern (2012) para. 15.6.
- In this context, an embedded derivative can be regarded as 'one or more implicit or explicit terms in a contract that affect the cash flows of the contract in a manner similar to a stand-alone derivative instrument', see: HMRC, *International Accounting Standards, Comparison Document* < [http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/comparison\\_document.pdf](http://webarchive.nationalarchives.gov.uk/20130129110402/http://www.hm-treasury.gov.uk/d/comparison_document.pdf) > accessed 15 May. 2015, para. 397; also: KPMG (2004), 20, Table 3.1.
- In the above example of the inflation index, the embedded feature would likely not qualify as a stand-alone derivative contract under IAS 39 (2009), para. 9, because a pure indexation is no financial instrument or other contract.



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