



Financial derivatives as a tool for Tax Planning

TAX

Financial derivatives as a tool for tax planning

- Accounting background
- IFRS – 32/39

Financial derivatives as a tool for tax planning

- Lack of understanding by tax authorities
- Unsophisticated treatment of derivatives under tax systems of many jurisdictions
- Arbitrage within one jurisdiction
- Arbitrage with banks (same jurisdiction)
- Arbitrage cross-border

International taxation – base concepts

- Withholding tax
- Tax treaties

International taxation – Thin Capitalisation

Example 1

Germany Company 1 Balance sheet

Fixed Assets	100	Related party debt	50
Receivables	100	Bank debt	50
Inventory	200	Equity (share capital and retained earnings)	300
	400		400

Debt: Equity ratio of 1:3 – Company 1 is not thinly capitalised

Germany Company Balance sheet 2

Fixed Assets	100	Related party debt	250
Receivables	100	Bank debt	100
Inventory	200	Equity	50
	400		400

Debt: Equity ratio of 7:1 – Company 2 is thinly capitalised

UK taxation

- Capital/Revenue distinction
- Treat all profits from derivatives as income

UK taxation

- Basis of recognition
- Accounting – hedging
- Contractual – disposal

UK taxation – anti avoidance

- Abuse of law
- Ramsay

International taxation – base concepts

- Diagram represents a US company which has a wholly owned UK subsidiary



International taxation – base concepts



- Diagram represents a US company which has made a loan to a UK company
- UK company is making interest payments on the loan. Interest is received by US company

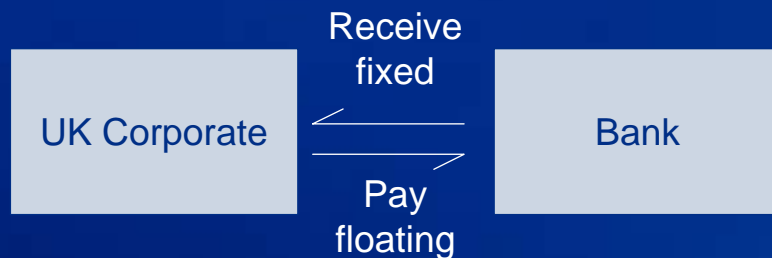
International taxation – base concepts

- US company has entered into an interest rate or currency swap with UK company



Interest rate swap

Capital loss into income deduction



- UK company enters into interest rate swap with Bank. UK corporate receives fixed and pays floating
- UK company sells 'receipts' leg of swap to Bank. Now has synthetic floating borrowing
- For UK company sale of receipts leg treated as capital receipt. Ongoing deductions obtained for payments under floating leg
- An example of turning one type of tax loss (unusable) into another (usable)

Currency swap

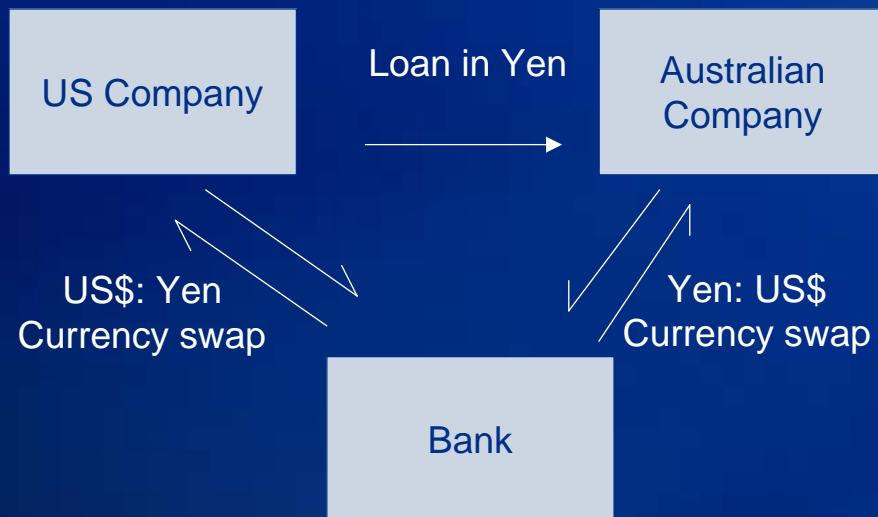
Avoidance of withholding tax

Before planning



- Australian corporate borrows US\$100 million from US related company at interest rate of 5%pa
- This gives a withholding tax cost of US\$0.5 million pa (10% withholding tax on interest of US\$5 million a year)

After planning



- Loan is redenominated into Yen. Now carries interest rate of 0.5% pa
- This gives withholding tax cost of US\$0.05 million pa (10% withholding tax on interest of US\$0.5 million a year)
- To avoid currency exposure equal and opposite currency swaps are entered into by Australian company and US company with Bank
- No withholding tax is levied on swap payments by Australian company to Bank or by Bank to US company

Currency swap

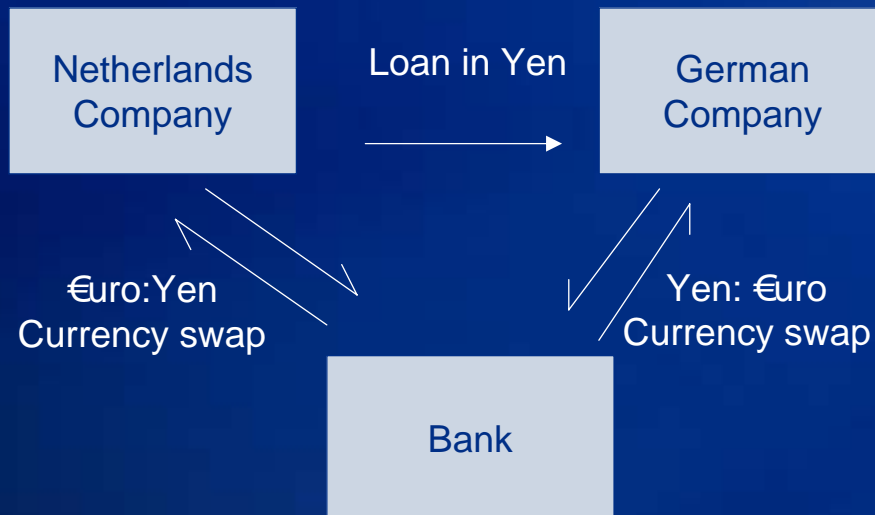
Mitigation of thin capitalisation

Before planning



- German company (with Foreign Parent) borrows €100 million from related Dutch company at interest rate of 5%
- German company is thinly capitalised and no tax deduction is given for interest paid of €5 million pa

After planning



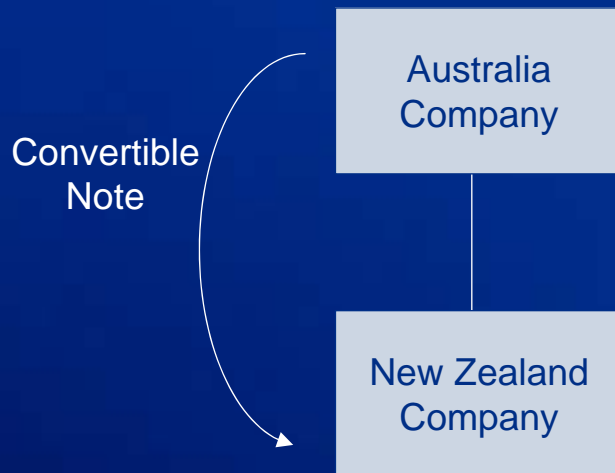
- Loan is redenominated in Yen. Now carries interest rate of 0.5% pa
- To avoid currency exposure equal and opposite currency swaps are entered into by German company and Dutch company with Bank
- German company does not get tax deduction for interest payment of €0.5 million pa but does get deduction for swap payment of €4.5 million pa to Bank

Convertibles

Types

- Classic
 - Loan with equity conversion feature at end of fixed period giving right for fixed number of shares in borrower determined at outset
- Reverse convertible
 - Borrower not lender has conversion right
- Embedded conversion features
 - Currency of repayment
 - Share rights

Zero – coupon convertible

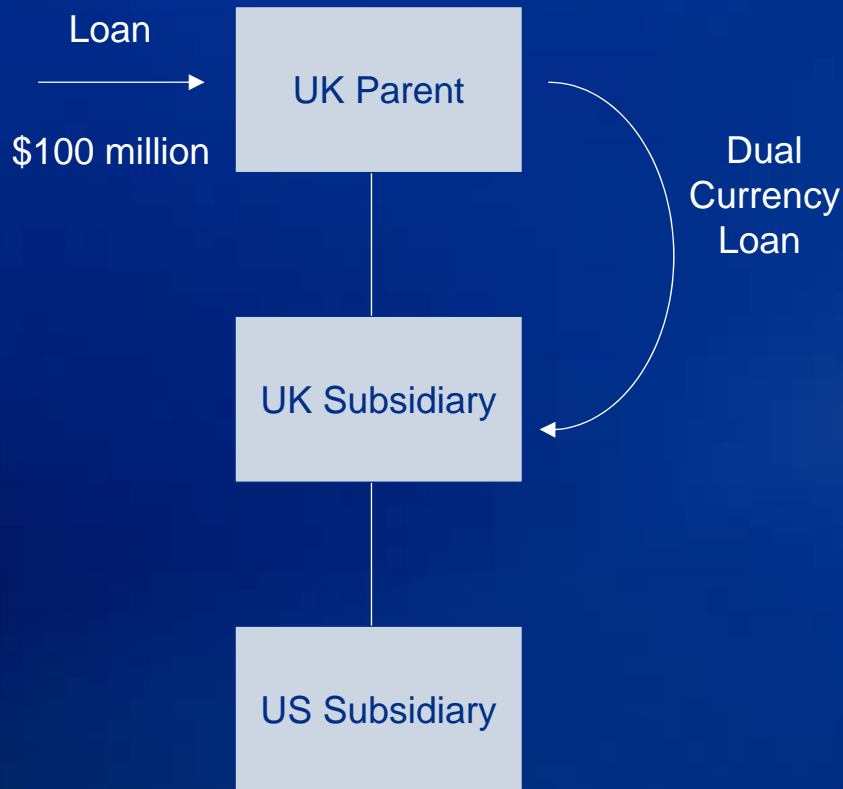


- New Zealand subsidiary issues a zero-coupon convertible to its Australian parent
- Terms of convertible note are
 - Issued at NZ\$100 million
 - No interest
 - Convertible at end of 10 years into NZ\$100 million common shares in New Zealand company at option of Australian parent or cash of NZ\$100 million
 - Value of NZ\$100 million common shares established at day one

Zero – coupon convertible

- Accounting treatment
 - Bifurcated on day one into debt NZ\$50 million and equity of NZ\$50 million. Debt of NZ\$50 million accretes to NZ\$100 million over 10 years
- Accounting gives accounting loss of NZ\$50 million to New Zealand company and accounting gain of NZ\$50 million to Australian parent (spread over 10 years)
- Tax
 - New Zealand follows accounting. Therefore tax deduction of NZ\$50 million
 - Australian treats convertible as equity. Income not taxed
- An example of cross-border arbitrage

Dual – currency loan



- UK parented group borrows \$100 million to acquire company in US (US subsidiary)
- UK parent lends to UK subsidiary under dual currency loan
- Term of loan
 - Repayable either for \$100 million or £60 million (exchange rate at day 1) at end of year 1 at option of UK Sub (the borrower)

Dual currency loan

Scenario 1

- Dollar strengthens so \$100 million is worth £70 million at end of year 1
- UK sub will repay £60 million. Sterling repayment so no matching for accounting purposes with investment in US subsidiary
- UK subsidiary has gain of £10 million in respect of investment in US subsidiary (NOT TAXED)
- UK parent has loss of £10 million in respect of borrowing of \$100 million (TAX DEDUCTIBLE)

Scenario 2

- Dollar weakens so \$100 million is worth £50 million at end of year 1
- UK sub will repay \$100 million. Accounting matches this with investment in US subsidiary (no accounting or tax gain or loss)
- UK parent receives \$100 million and owes \$100 million therefore no accounting or tax income or deduction
- Affirmative use of accounting rules to give one-way tax bet

Options

Creating a tax free deposit via FTSE box

- Corporate with surplus funds creates an interest equivalent return by purchasing and selling options over FTSE
- Example assumes 750 units
- Transaction

Buy call at 2844 (ie profit on increase in index above 2844) for	(168.75)
Sell put at 2844 (ie loss on decrease in index below 2844) for	112.50
Buy put at 2950 (ie profit on decrease in index below 2950) for	(37.50)
Sell call at 2950 (ie loss on increase in index above 2950) for	<u>18.75</u>
Initial outlay	<u>(75.0)</u>

- Outcome

FTSE level	Bought call at 2844	Sold call at 2950	Bought put at 2950	Sold put at 2844	Profit
2800	0	0	112.5*	(33)**	79.5
2844	0	0	79.5	0	79.5
2900	42	0	37.5	0	79.5
2950	79.5	0	0	0	79.5
3000	117.0	(37.5)	0	0	79.5

* $(2950 - 2800) \times .75 = 112.5$

** $(2800 - 2844) \times .75 = (33)$