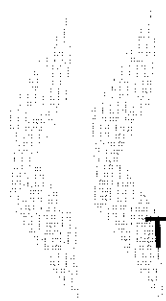
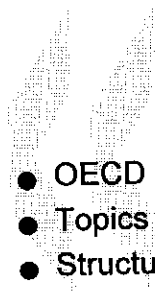


會議相關附件



Taxation of Financial Markets

1 – Introduction



Introduction

- OECD overview
- Topics
- Structure

Member Countries of the OECD

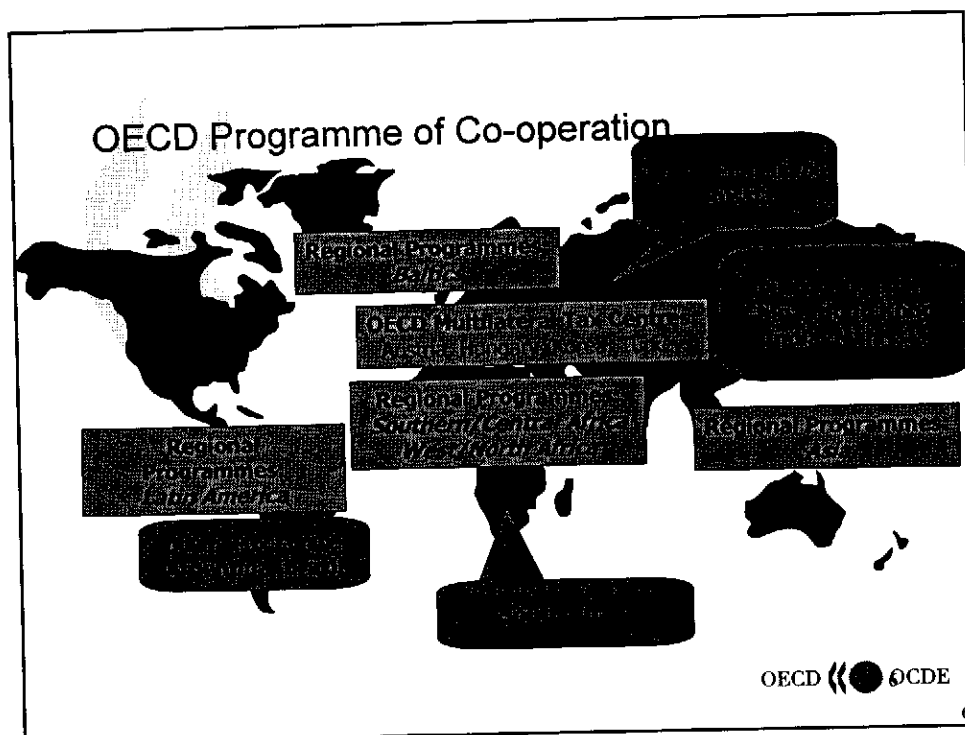
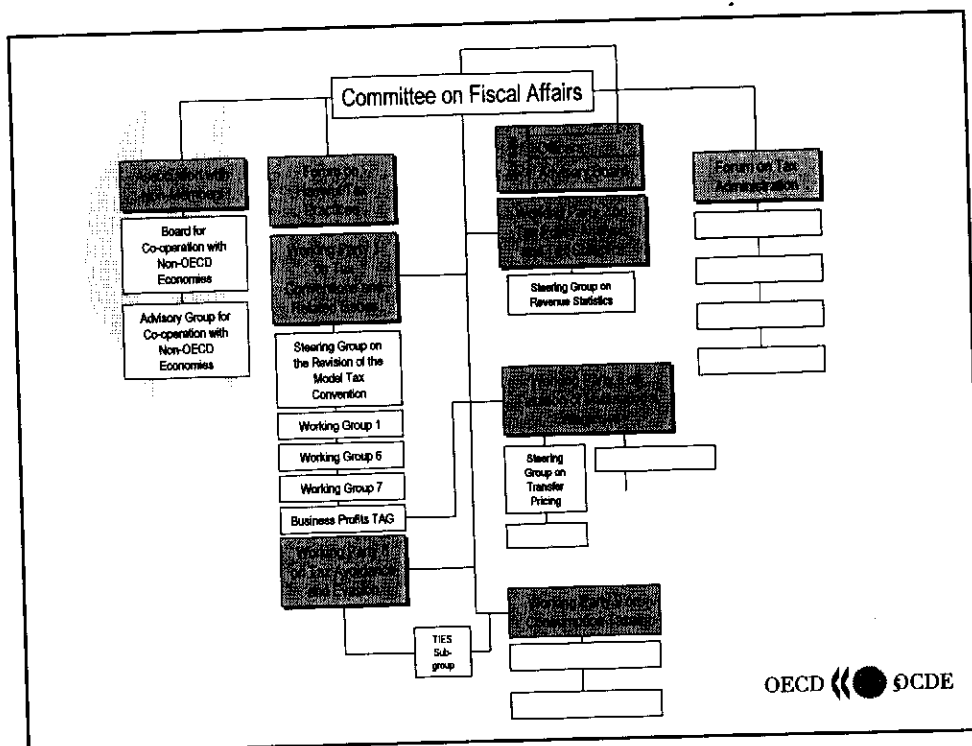
- | | |
|------------------|-------------------|
| ■ Australia | ■ Korea |
| ■ Austria | ■ Luxembourg |
| ■ Belgium | ■ Mexico |
| ■ Canada | ■ Netherlands |
| ■ Czech Republic | ■ New Zealand |
| ■ Denmark | ■ Norway |
| ■ Finland | ■ Poland |
| ■ France | ■ Portugal |
| ■ Germany | ■ Spain |
| ■ Greece | ■ Slovak Republic |
| ■ Hungary | ■ Sweden |
| ■ Iceland | ■ Switzerland |
| ■ Ireland | ■ Turkey |
| ■ Italy | ■ United Kingdom |
| ■ Japan | ■ United States |



3

Expansion of OECD

- Accession countries
 - Chile, Estonia, Israel, Russia, Slovenia
- Enhanced engagement
 - Brazil, China, India, Indonesia, South Africa
 - ASEAN region



Objective of International Co-operation on Taxation

- Removing fiscal barriers to trade and investment
- Countering tax avoidance and evasion
- Facilitating the exchange of information between tax authorities
- Eliminating Harmful Tax Practices and
- Improving the effectiveness of tax administrations

Topics

- **Financial Instruments**
 - Debt, equity, hybrid instruments
 - Commercial uses and policy issues
- **Derivative Instruments**
 - Forwards, options, swaps
 - Commercial uses and policy issues
- **Financial avoidance**
 - Sales that are not sales
 - Income as capital

Topics

- Anti avoidance
- Collective Investment Vehicles (inc Private equity)
 - What are they
 - Tax Policy Issues
- Attribution of Profits to Permanent Establishments in financial sector

OECD's Work (1)

<Financial Instrument & Transaction Area>

- Publication: Taxation of New Financial Instruments (1994)
- In 1994: Special Sessions on Innovative Financial Transactions (SSIFT)
 - Focuses on financial instruments and providers of the financial instruments (e.g. banks, intermediaries)
- Report: Globalization of Financial MKT and the Tax Treatment of Income and Capital (1995)

OECD's Work (2)

→ Reports:

- Innovative Financial Transactions : Tax Policy Implication (1997)
- Attribution of Profits to Permanent Establishments Parts II and III (final 2007)
<http://www.oecd.org/dataoecd/20/36/41031455.pdf>
- New Article 7 and Commentary
<http://www.oecd.org/dataoecd/37/8/40974117.pdf>
- Continuing dialogue with Non-OECD Economies

Aim of Seminar/Workshop

- Increase understanding of tax policy and administrative challenges arising from financial market innovations
- Explore issues in the taxation of new financial instruments such as hybrids, foreign currency arrangements, derivatives, hedging instruments and synthetics
- Share country experiences

Challenges for Tax Authorities

- Overall Challenge
 - Sensible tax policies and administrative approaches
 - Supported by strategies to deal with avoidance/evasion
- Specific examples of these challenges
 - Integrated financial services: necessary to have complicated transfer pricing rules
 - Increasingly mobile tax base that is sensitive to tax differentials
 - Outflows of financial activities to tax haven / offshore financial market
 - Temptation towards harmful tax competition

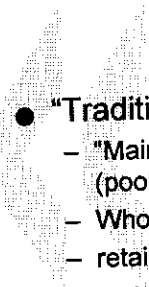
Structure of Dialogue

- Introduction on key issues
 - analysis of issues and tax policy and administrative options
- Sharing of experience
 - ongoing dialogue in formal sessions and case examples
 - Sample different approaches adopted in different countries and their experience
- Discussions



Taxation of Financial Markets

3 - Framework



Nature of Banking Business

- “Traditional Banking”
 - “Main business is the intermediation of savers and borrows (pooling of savings).
 - Wholesale
 - retail
- Core business activities:
 - Borrowing and lending money
 - financial intermediation
- “Investment Banking”
 - Mergers and acquisitions
 - Derivatives
 - Trading in stocks, shares

Recent Trends

- Business is global
- Income becoming more varied due to investments in new financial products (e.g. discounts, premiums, foreign exchange gains and losses)
- Transaction fees are replacing investment margins as the main income source
- Derivatives are becoming increasingly a part of banking businesses
- International accounting standards for banks are changing

Typical Balance Sheet

Assets	Liabilities
Cash balances at central bank	Deposits by banks
Loans and advances	Customer accounts
Treasury and other bills	Debt securities in issue
Securities	Other liabilities
Shares	Accruals/deferred income
Intangible fixed assets	Subordinated liabilities
Tangible fixed assets	Provisions (pension, tax)
Other assets	Capital And Reserves
Prepayments, accrued income	Subscribed capital
	Retained earnings
	Revaluation reserve
	Other reserves

Profits of Banks

1 Interest on loans & advances	Interest, discounts and premiums accrued as revenue (in loan account)
2 Return on securities and shares	Traded assets: valued a market value or lower of market value and cost. Investment assets: gains on disposition of shares may be capital gains, and interest, discounts and premiums on debt securities accrued. After-tax financing: preferred shares
3 Fees and lease income	Guarantee fees and fees on other off-balance transactions After-tax financing: leasing
4 TOTAL REVENUE	
5 Interest expenses	Interest, discounts, premiums, prepayments of interest and other expenses may be accrued as expense against revenue
6 Increase in loan losses provision	Bad debts deductible and in some countries specific provisions and general provisions
7 Net operating expenses	Accrual of prepaid expenses
8 TOTAL DEDUCTIONS	
9 PROFIT (LOSS)	Small profit margin relative to assets

OECD  OCDE

How Banks Make Money

- Buy cheap and sell dear
 - Loans eg difference between deposit rates and overdraft rates
 - Currency
 - Derivatives
- “Bid/offer spread”
- Interbank price

OECD  OCDE

How Banks Make Money

- Foreign exchange
- Customer 1 wants to exchange \$100 for Yuan,
 - Bank pays 800 Yn for \$100 (i.e bank buys \$100 for Yn800)
- Customer 2 wants to exchange Yuan for \$100
 - Customer pays 850Yn for \$100 (i.e. banks sells \$100 for Yn 850)
- Bank makes profit of 50
- Interbank rate 825 for 100
- Key feature – bank can make money whatever currency fluctuations

How Banks Make Money

- Bank can buy from customer at 800 and sell to other bank for 825
- But
- More profitable to wait for another customer to sell for 850 “natural offset”
- Managing risk: leaving a portion of the portfolio “unhedged”

Banking activities

- Using the balance sheet
- Securitisation
 - Own assets
 - As a fee earning service to others
 - Accounting treatment see 2b UK Securitisation Rules
- Repos
 - Brief explanation
 - NZ experience
 - Avoidance examples later

Overview of Financial Market Taxation

- Taxation affects financial market activities in many ways
 - Types of taxes imposed (e.g. income tax: net basis or withholding basis, consumption tax, transaction tax)
 - Taxes imposed on different participants (e.g. corporate, institutional investors, different financial intermediaries, individual investors) and their activities (e.g. corporate finance, leasing, hedging, insurance, investment, etc.)
 - Taxes on different types of incomes arising from financial market activities (e.g. interests, dividends, gains on assets etc.)

Taxes on Financial Activities

- **Income Taxes**
 - Focuses on taxing incomes and profits
 - Net Basis, Residence Country Tax
 - Gross Basis, Source Country Tax
- **Consumption Taxes**
 - VAT/Sales tax
- **Transaction Taxes**
 - Stamp tax/duty

Other Taxes

- **Stamp duty : tax on document**
 - fixed or ad valorem (% of value of transaction)
 - no document - no tax
 - stamp duty reserve tax : tax on transaction
 - general trend is away from this type of transaction tax and replace with VAT where possible
- **VAT : financial services usually exempt**
 - can be problematic
 - some taxes from irrecoverable input tax
- **Do your countries have stamp duty/ VAT**

Participants in financial markets

- Companies
 - As borrowers, investors, hedgers
- Institutional Investors
 - Collective investment funds
- Individuals
- Banks

Corporate Tax (1)

- Accounting rules
- International tax rules
- Anti avoidance
- Deductions for interest and other financial costs
- Deductions for hedging costs

Corporate Tax (1)

- Sophisticated rules to measure profits
 - broadly follow accounting treatment
 - [but watch for changing accounting standards]
 - acceptance of "mark to market"
 - bad debt relief for trading losses

Corporate Tax (2)

- International rules
 - transfer pricing (Article 9 of OECD Model)
 - branch rules (Article 7 of OECD Model)
 - branch capital of banks
- Anti-abuse rules
 - anti-avoidance rules
 - general anti-avoidance rules
 - specific anti-avoidance rules e.g. tax credit abuse / loan parking
 - Controlled Foreign Company (CFC) rules

Taxation of Corporate Finance

- What is the tax treatment of corporate finance under the corporate tax?
- Debt
 - Interest Expense
 - Deductibility
 - Accrual
- Equity
 - Dividends on Common Stock
 - Dividends on Preferred Stock

Taxation of Corporate Hedging Transactions

- Basic Business Uses of Hedging Transactions
 - To manage foreign currency and interest rate risks
 - Important for multinational corporations
- Main tax issues
 - Timing
 - Amount
 - Character
 - Source
 - Whether tax rules should follow the hedge accounting approach

Taxation of Institutional Investors

- Classes of Institutional Investors
- Taxable Treatment
- Tax Transparent Treatment

Taxation of Individual Investors

- Measurement and Recognition of Income
 - Various forms of income from different types of investments
 - Neutrality is an important consideration
- Allowance of Deductions
- Incentives for Savings
 - Capital Gains and Losses
 - Retirement Savings
 - Medical and Educational Savings
- Possible Models of Taxation

Taxation of Interests

- **Payer/Companies making interest payment:**
 - Withholding tax: exemption for payments to banks, intra-group, to non-residents under treaty, government bonds
 - Corporate tax: usually deductible, often subject to conditions
- **Recipient of interests: may include exemption for non tax payers**
 - non working partners, low income earners
 - non residents
 - Timing issue: when do interests income become taxable?

Taxation of Dividends

- **Three options**
 - full imputation (in New Zealand)
 - classical system (in US)
 - Partial imputation – old UK approach
- **No dividend deduction for company**
- **Taxation of shareholder on gross**
 - But can set tax credit against tax liability
- **Tax credit may be repayable if exempt**

Taxation of Capital Gains

- Varied from country to country
- Where capital gains are taxable, usually at a reduced rate or subject to additional tests before becoming taxable
- Capital gains tax on individual investors
 - substantial exemption

Taxation of Profits of Banks

- Should banks be taxed on the basis of “best” accounting practice, the normal company tax rules or special taxation rules for banks?
 - Different items of income/expenditure of banks may require different solution
 - A complex issue
 - Need to understand how each items of income/expenditure is dealt with under these different approaches
 - Mainly dealing with timing issues

Timing of Recognition

- Accounting for income and expenses
 - i.e. when should amount of interest be recognised for tax purposes
- Four possibilities
 - received or paid (cash basis)
 - receivable or payable (realisation basis)
 - allocable as earned or incurred (accruals)
 - cash flow valuation (mark to market)
- Common practice: a mixture
 - accrual (e.g. for banking activities)
 - mark to market (e.g. for trading activities)

Example: Allocation of Income

- 12% interest on 100 debt :
 - lent Dec. 1 2008 (31/12 accounting date)
 - term of one year, single interest payment
 - interest not received until Jan. 1 2010

	2008	2009	2010
Cash	0	0	12
Receivable	0	12	0
Accrual	1	11	0

Mark to market (MTM)

- Market valuation includes gains and losses as they accrue
 - value related to market movements as well as accruing income
 - should be on income account not capital gains
 - parallel treatment of assets and liabilities

Taxation of Interest Expense

- Interest expense is the main cost of banking business resulting from bank's borrowings
 - A mixture of long term, medium term and short term (e.g. on-demand accounts)
 - A mixture of costs: from mostly cost-free borrowing such as current accounts to fixed rate bonds
- When is the expense deductible for tax purposes?
 - Accrual under accounting practice
 - Realisation under normal tax rules
- What is your country's practice?

Special Rules

- Interest expense is subject to many special rules
 - particularly for banks but also true generally
- Mainly avoidance focus
 - Limit deductions if higher than normal commercial rate
 - Limit deductions if interests are related to non-recourse loans, etc. that are in substance equity instruments
 - Limit deductions under thin capitalisation rules if paid to related parties under specified circumstances (e.g. in substance equity)
 - Earnings stripping rules
- What limitations do your country's tax rules impose on interest expense of banks?

OECD  OCDE

Taxation of Interest Income

- Interest income of banks are derived from a range of lending activities
 - Different holders (e.g. governments, other banks and financial intermediaries, corporate issuers, individuals)
 - Different commercial rates depending on lengths, credit risks and market conditions
 - Using different types of instruments (e.g. commercial/government bonds carrying rights to interests at market rate or with discounts or premiums; zero coupon bonds; fixed rate preference shares; convertible bonds; foreign currency bonds)
- When are these incomes of banks are brought to tax in your country?
 - accrual or realisation

OECD  OCDE

Taxation of Fees

- Increasingly an important part of banking profits
- Also becoming more important as substitutes for margins (i.e. net interest income)
- Fees can be derived from a wide range of financial services (e.g. guarantee and credit reference, advice on corporate finance, intermediation of innovative arrangements such as securitisation etc.)
- When should fees income be subject to tax?
 - Accrual basis as in accounting practice or realisation basis as in normal tax rules?
 - What is your country's practice? Why?

Taxation of Non-Interest Income

- Banks hold many current assets
 - funds which a bank needs to maintain and invest to enable it to meet any likely demand from depositors; and
 - Securities which are held for trading purposes
- These give rise to income other than interests (e.g. gains on capital, forex gains, dividends, etc.)
- Should these income be brought to tax on an accrual basis or realisation basis?
 - Marked to market trading securities for tax purposes?
 - What is your country's approach?

Taxation of Gains and Losses on Fixed Assets

- Fixed assets of banks are similar to other commercial companies
- Gains or losses can be realised in more innovative ways (e.g. securitisation)
- When should gains and losses on fixed assets be brought to tax?
 - Gains and losses are taxed under normal tax rules on realisation basis
 - Have you come across any innovative ways of realisation?
What can you do in those cases?

Taxation of Financial Markets

3 - Innovative Financial Instruments

Types of Financial Transactions

- Financing
- Hedging
- Cash flow management
- Trading, investment and speculative

Financial Market Developments

- Removal of national barriers to the free flow of capital
 - Relaxation of exchange controls, electronic transfers, etc.
 - Improved efficiency in the global allocation of savings and investments
- Increasing variations in the types of financial instruments
 - Driven by economic volatility in interest rates, exchange rates and prices resulting from market liberalisation
 - Types of instruments broadly include financing instruments, hedging instruments and speculative instruments
 - Also more variety that could not be easily classified

Characteristics of a Financial Instrument?

- A financial instrument conveys a bundle of rights and obligations to issuers/holders
 - obligation to accept direction from holders/right to vote
 - obligation/right to periodic payments
 - acceptance of default/credit risks
 - obligation/right to payments upon winding up
 - right to sell or liquidate
 - obligation/right of refund upon maturity

Financial Instrument – IAS 32



- Financial instrument – a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity
- Financial liability – a contractual obligation to deliver cash or financial assets to another entity, or a contract that may be settled in the entity's own equity instruments
- Equity instrument – residual interest in an entity's assets after deducting all liabilities
- Follows the economic substance rather than the legal form



5

Debt or equity



- Debt
 - Repayable – specific date, on demand, or contingent
 - High ranking in event of bankruptcy – though may be subordinate
 - Predictable return – interest, discount
 - Ranks above equity - lower risk
- Equity
 - Ownership – voting rights
 - Perpetual capital
 - Profit dependent return
 - Ranks below all other creditors - higher risk



6

Example - Simple Debt and Equity



J Co is manufacturer taking advantage of the low labour costs, high productivity and abundant raw materials of Nirvana. They need \$100 over a 5 year term to fund an expansion programme.

(a) Bank A advises J Co that it can provide funding on the following terms. A 5-year \$ loan at a fixed interest rate of 16%. Interest is payable annually in arrears and the principal is repayable at the end of the loan term.

(b) Alternatively J Co. could obtain the necessary finance by issuing more shares to the existing shareholders for \$100. If things go according to plan, J Co expects to pay about 10% dividend over the next 5 years and its share price is also expected to increase by 50% over the next 5 years. As part of the financing plan, S Co. intends to take the shares in 5 years.

Q 1 What are the projected cash flows of options (a) and (b)

Q2 What are commercial pros and cons from perspective of J Co

Q3 What are commercial pros and cons from perspective of investors



7

Current Tax System



■ Typically differentiate between debt and equity

- Interest is paid under debt instruments
- Dividends are paid under equity instruments

■ Common tax characteristics

- Debts: interest taxed as income on an accrual basis, subject to withholding taxes on cash basis, deductible to payer on accrual basis, principal is not subject to tax
- Equity: dividends taxed as income on realisation basis, imputation credits may be attached, subject to withholding taxes on cash basis (but has a lower rate under tax treaties), not deductible to payer, capital is not taxed but capital gains are taxed as income, often at a lower rate.



8

After Tax Cost of Finance



Interest Payment of	100	Dividend of	100
Tax Rate of 30%			
Reduces tax by	(30)		0
After Tax Cost	70		100

Debt is cheaper than equity for borrowers after tax



9

After Tax Return on Investment



Interest Received	100
Tax Rate of 30%	<u>(30)</u>
After Tax Return	70

Exemption system

Dividend received	100
Tax	<u>0</u>
After Tax Return	100

Credit system

Dividend		100
Tax at 30%	30	
Tax Credit	<u>(20)</u>	(10)
After Tax return		90



10

Tax Treatment in the Home State



■ Debt Finance

- Interest received taxable with credits allowed for foreign taxes paid
- Tax credits may be available on withholding taxes paid in source state

■ Equity Finance

- Dividends may be exempt (on the basis of participation), partially exempt or taxable (with tax credits allowed)
- Direct credit system allows tax credits on dividend withholding taxes paid (if any)
- Indirect credit system allows tax credits on underlying company income taxes paid – but usually not available under classical system



11

After Tax Return on Investment



Interest Received	100
Tax Rate of 30%	<u>(30)</u>
After Tax Return	70

Exemption system

Dividend received	100
Tax	<u>0</u>
After Tax Return	100

Credit system

Dividend	100
Tax at 30%	30
Tax Credit	<u>(20)</u> (10)
After Tax return	90



12

Innovative Financial Instruments



- Unbundling of the rights and obligations
- Economic substance or legal form?
- Preference shares
 - redeemable?
 - fixed rate?
 - cumulative?
 - participating?
- Example: 9% fixed rate preference shares redeemable in 10 years
- Redeemable preference shares may be accounted for as a financial liability rather than equity



13

Innovative Financial Instruments



- Notes and Bonds
 - perpetual
 - equity notes
 - zero coupon bonds
 - convertible
 - participate in earnings by linking interest with equity returns
- Example: a 10 year, zero-coupon bond issued at a 9% discount
- 'Innovative tier 1 capital'
- Do you have such instruments in you country?
- How do you treat them?



14

'Hybrid instruments'

- IAS 39 – 'hybrid instrument' – a 'non-derivative host contract' with an 'embedded derivative'
- Convertibles: loan with a conversion option
- Exchangeables
- Asset-linked
- Split accounting
 - ?mandatory convertible

Example – Various Funding Instruments

S Co is a company resident in New Zealand. It is looking into an expansion into the Chinese market and the way to fund the expansion, which requires Yuan 8 mil (about US\$ 1mil) for a period of three years. Upon enquiries with its banker, several options were suggested by the bank to S Co.

Option 1: take out a loan in NZD (approx \$4 mil), at a market interest rate in New Zealand of 8%

Option 2: take out a loan in USD (approx \$1 mil), at a market interest rate of 10%

Option 3: issue notes to its existing shareholders (in NZD of \$4 mil) that will be converted into shares of S Co at the end of three years. The note will carry a fixed interest rate of 6%

Commercial reasons for using hybrids



■ Convertibles

- For the issuer
 - cheaper finance
 - ties in the investor
 - attractive to start-ups, or companies that are already indebted
- For the holder
 - share in the upside
 - less downside risk

■ Asset-linked securities

- avoids transaction costs
- attractive in inflationary times



17

Summary of tax Issues



- Treatment of the transaction
 - **character** of gains / losses
 - **timing and amount** of recognition of transaction
 - **source** of income in international transactions
 - treatment of non-residents
 - **method** of taxation
- Treatment of the payer/recipient
 - Different (?favourable) treatment for regulated financial intermediaries ?
- Arbitrage and tax avoidance
 - Domestic : taxpayers in different regimes
 - e.g. issuer on accruals / investor on cash basis
 - Cross border debt-equity arbitrage opportunities

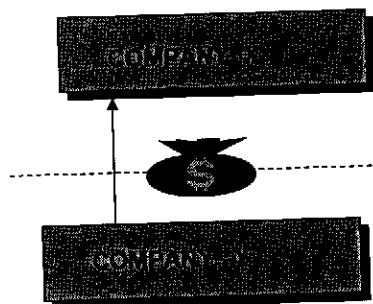


18

Asymmetrical Treatment of Innovative Financial Instruments



Redeemable Shares/Equity Notes



COUNTRY A
TREATS DIVIDENDS/INTEREST
ON REDEEMABLE
SHARES/NOTES AS DIVIDENDS:
PARTICIPATION EXEMPTION (no
tax)

COUNTRY B
TREATS DIVIDENDS/INTEREST
ON REDEEMABLE SHARES/NOTES
AS INTEREST (deductible)

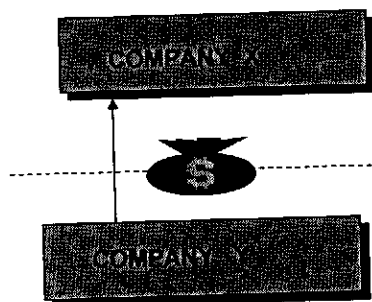


19

Asymmetrical Treatment of Innovative Financial Instruments



Mandatory convertible



COUNTRY A: HOLDER
TREATS MANDATORY AS
EQUITY: SELLS WITH ACCRUED
INTEREST: TAXED AS CAPITAL
GAIN

COUNTRY B: ISSUER
TREATS MANDATORY AS DEBT:
ACCRUED INTEREST DEDUCTIBLE



20



Taxation of Financial Instruments

5 – Corporate Hedging Activities (Forwards and Futures)



What are Derivatives?

- A financial instrument (ie, a contract) the value of which depends on the value of another underlying asset / reference rate / index
- DFIs commonly based on:
 - interest rates
 - foreign currency exchange rates
 - share prices (or index of share prices)
 - commodity prices

Types of Derivative Instruments

- All DFIs based on 2 basic transactions
- **Forward contract**
Contract requiring the delivery of a quantity of a product at an agreed price / date / place
- **Option (call / put)**
Right (not obligation) to buy/sell a quantity of a product at an agreed price / date
- **Swap**
 - Exchange of cash flows

USES OF DFIs

- Risk management / hedging - eg, protecting against changes to revenue / costs
- Speculation and arbitrage - trading in DFIs for profit
- Cash flow management - eg, selling next year's output for current cash
- How do you distinguish between contracts entered into for hedging and cash flow management purposes? Hedging and speculative purposes?

COMMON DFIs - FORWARDS

- Forward contract
Contract requiring the delivery of a quantity of a product at an agreed price / date / place
- Similar to futures contract, but "forward" is used to signify individualised OTC (Over the counter) contracts
- Arose in trade in agricultural commodities

Common Derivatives - FORWARDS

- NB forward price is not a guess at future price, rather it is the cost of carrying the asset until the maturity of the contract
- For physical assets like wheat or oil the cost may include such things as interest rates, insurance storage etc
- For financial assets, cost of carry is just the short term rate of interest.

Common Derivatives - FORWARDS

- **Example**

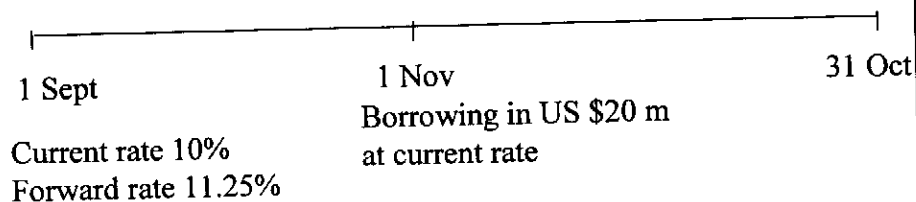
- Current (or spot) price of share = 100
- Interest rate = 10%
- No dividends expected to be paid
- Future price of 12 months is
 - 110
- As cost of buying share today for 100 and holding for a year is same as investing 100 at 10% and buying share 12 months later for 110.

OECD  OCDE

Example - Forwards

On 1 September Company A knows that it will borrow \$20m on 1 Nov for 12 months.

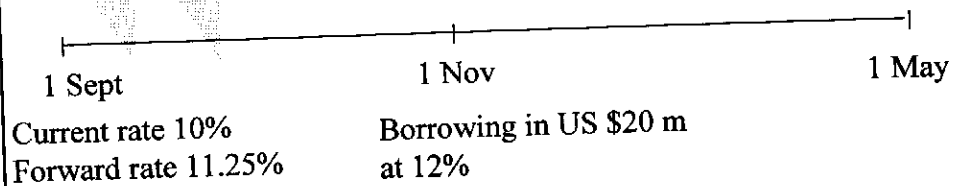
Current rate is at 10%, so Co A is exposed to interest rate movements



OECD  OCDE

Forwards - Example (Outcome 1)

Co A enters into a Forward Rate Agreement to lock in the borrowing interest rate at 11.25%. On 1 Nov, the market interest rate for a loan with 31 Oct settlement is 12%

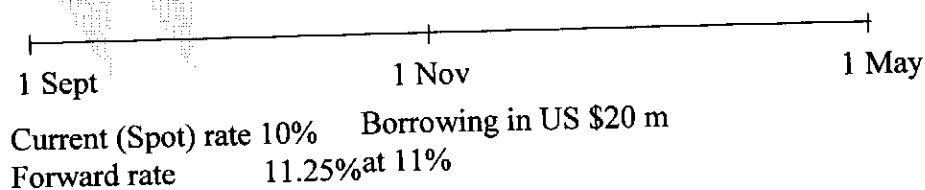


$$\begin{aligned} \text{Interest payment on loan} &= 12\% \times \$20\text{m} &= \$2.4\text{m} \\ \text{Receipt under FRA:} &= 0.75\% \times \text{US\$}20\text{m} &= \$150,000 \end{aligned}$$

OECD  OCDE

Forwards - Example (Outcome 2)

On 1 Nov, the market interest rate for a loan with 31 Oct settlement is 11%



$$\begin{aligned} \text{Interest payment on loan} &= 11\% \times \$20\text{m} &= \$2.2\text{m} \\ \text{Payment under FRA} &= 0.25\% \times \$20\text{m} &= \$50,000 \end{aligned}$$

OECD  OCDE

Tax Issues - Country Approaches

- Under Outcome 1:
 - Would your tax system allow Co A to deduct all \$2.4 mil interest? Specify the conditions that would have to be met.
 - Would you tax the \$150,000 gain from the bank? If so, how and when are the gains brought to tax?
- Under Outcome 2
 - Would your tax system allow the 50,000 loss
- Does the tax treatment of the forward contract depend on whether the contract was entered into for hedging, speculative or cash flow management purposes?
 - What factors are taken into account?

COMMON DFIs - FUTURES

- Futures contract
Contract requiring the delivery of a quantity of a product at an agreed price / date / place
- A "future" is used to indicate highly standardised forward contracts.
- Standardised for easy trading:
 - » few set maturity dates / term-length
 - » written for standard products / amounts
- Enter into equal and opposite futures to "lock in" gains and losses before contract maturity

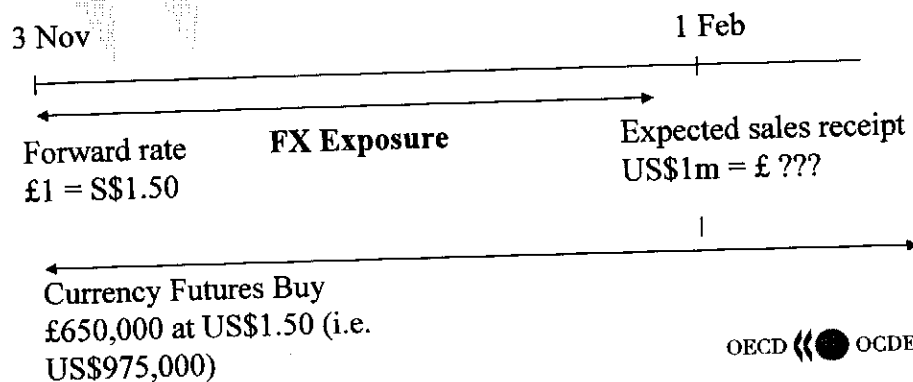
Example - Currency Futures

- 3 Nov UK Co sells goods for US\$ 1m due for payment on 1 Feb.
- 3 Nov Spot rate $\text{£}1 = \$1.40$
 - \$1m is worth $\text{£}710,000$ = Recorded in sales of UK CO
- If 3 Feb Spot rate is $\text{£}1 = \$1.30$ 1 Feb
 - \$1m will be worth $\text{£}770,000$ = **Foreign Exchange gain**
 - (expected to receive 710k, but actually received 770k)
- If Feb Spot rate is $\text{£}1 = \$1.50$
 - \$1m will be worth $\text{£}670,000$ = **Foreign Exchange loss**
 - (expected to receive 710k, but actually received 670k)
- Decides to manage FX exposure by currency futures as follows:

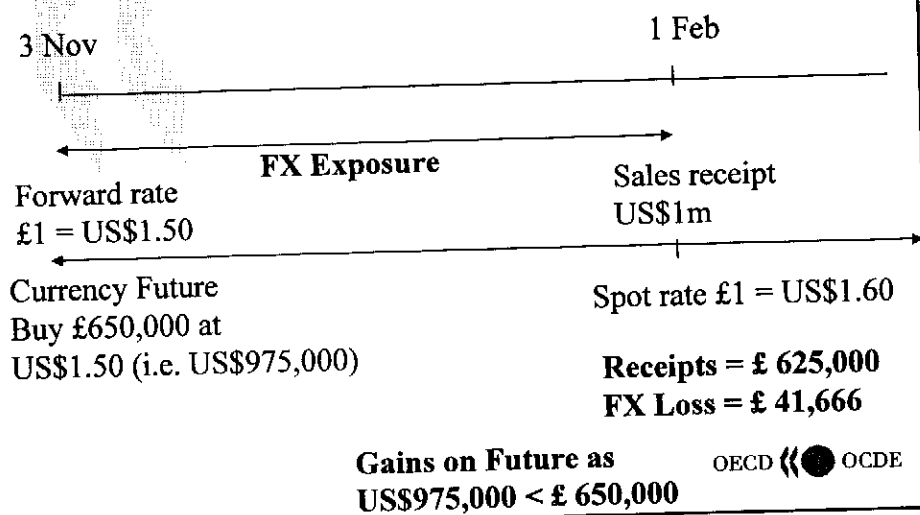
Futures Example

- Forward rate $\text{£}1 = \$1.50$
- Enters into futures contract to
 - Buy $\text{£} 625,000$
 - for $\$975,000$
 - On 1 Feb

Example - Currency Futures



Example - Currency Futures



Example - Currency Future

Overall result of transactions on 1 Feb:

Receivables £		Currency Futures (\$)	
expected	666,666	Under future £ 650,000 costs	975,000
received	<u>625,000</u>	Spot price would be	<u>1,040,000</u>
FX Loss	(<u>41,666</u>)	profit	\$ <u>65,000</u>
		=	£ 40,625 (spot rate 1.60)

Note: Due to the standardised format of futures contracts, the hedge was not a perfect one, resulting in an overall loss of £1,041. On 1 Feb, although the futures have not matured, the profits on these currency futures can be "locked in" by entering into an equal and opposite futures (e.g. sell £650,000 at the forward rate on 1 Feb of US\$1.60 (i.e. US\$1,040,000))

OECD  OCDE

Tax Issues – Characterisation and Timing

- How do you characterise the payment made under forward and futures contracts?
 - Income or capital payment?
 - Interest/dividend?
 - Withholding taxes?
- If payments are made across border out of or into your country, how do you characterise these payments for treaty purposes?
- When is the payment taxable?
 - Accrual or realisation (when the payment becomes payable)
 - When the payment is made (ie. cash basis)

OECD  OCDE

Tax Issues: Hedging Rules

- **Does your country employ hedging rules to deal with the taxation of hedging activities?**
 - What are the reasons for these rules?
 - What are their advantages and disadvantages?
- **If your country does not employ hedging rules, how do you ensure that there is consistency in the tax treatment of a fully hedged relationship?**
 - Characterisation mismatch
 - Timing mismatch, etc.

Taxation of Financial Instruments

7 – Options and Swaps

COMMON DFIs - OPTIONS

- **Option**
Right (not obligation) to buy / sell a quantity of a product at an agreed price ("strike price") / date
- **Option can be:**
 - » call option - require seller to deliver
 - » put option - require buyer to accept
- **Used as a means of limiting risk while permitting unlimited gain. Option holder's potential loss is limited to premium paid**
- **In practice, most financial options settled in cash**

Common DFIs - Options

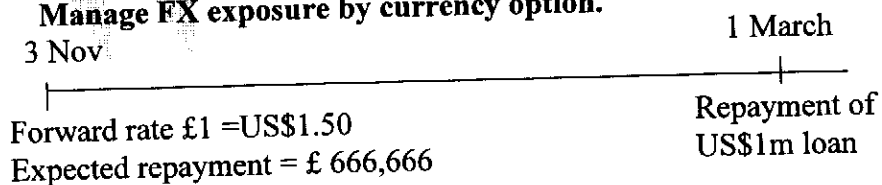
- Principle of options known since Ancient Greece, but development of valuation models paved way for financial options
- Now used to manage cost of:
 - » foreign currency - foreign currency options
 - » borrowed funds - interest rate caps / floors / collars
 - » commodities - gold / oil / minerals
- May be traded on exchange, or "over the counter"
- Price of options = intrinsic value plus time value
 - Intrinsic value: benefit to the holder if option exercised immediately (nil for options where market price is equal strike price)
 - Time value: depends on remaining life to expiry, volatility of the prices of the underlying assets and holding cost of the underlying asset (e.g. interest that the writer has to pay to hold the asset)

OECD  OCDE

Options - Example

UK Co has an existing US\$ loan on 3 Nov and expects to repay on 1 March. Forward rate on 3 Nov £1 = US\$1.50 - but may be different on 1 March (FX exposure)

Manage FX exposure by currency option.

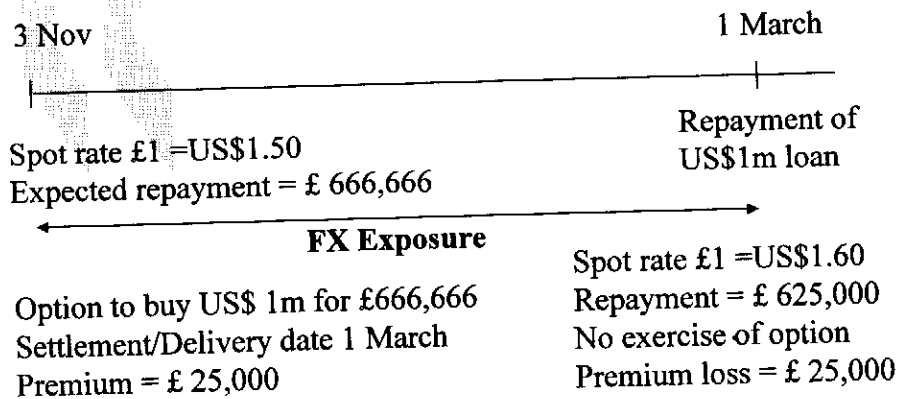


FX Exposure

Option to buy US\$1m for £666,666
 Settlement/Delivery date 1 March
 Premium = £ 25,000

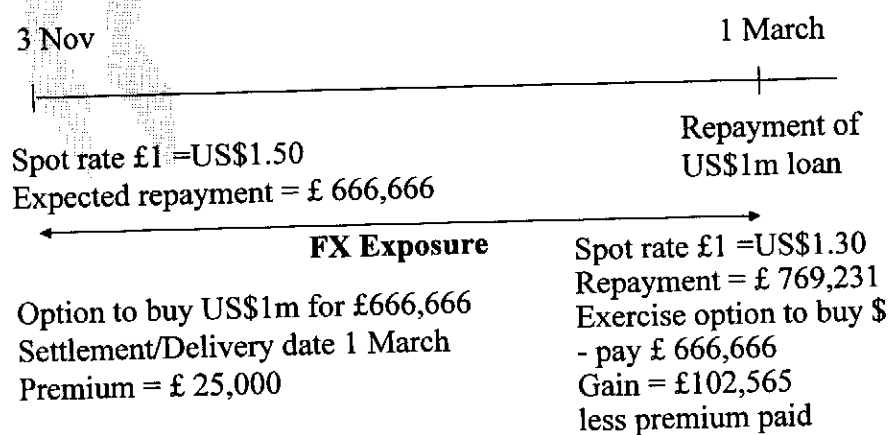
OECD  OCDE

Options - Example (Outcome 1)



OECD  OCDE

Options - Example (Outcome 2)



OECD  OCDE

Options - example (outcome 3)

UK company agrees with lender to extend borrowing for further 2 years - so doesn't need to repay US\$1m on 1 March.

Exchange rate on 1 March £1 = \$1.30

Terms of option permit net settlement in cash

UK company exercises option, but no US dollars change hands

Option writer pays UK co £102,565 - difference between strike price and spot price for US\$1m

Tax Issues (1)

- What is the character of the option premiums on 3 November?
 - Expenditure or capital?
 - If the premiums were paid into or out of your country, how do you treat these payments under the tax treaty?
- Will the value of the outstanding option on the balance date be brought to tax?
 - If so, what method can be used to calculate the gains/losses for UK Co?
 - How do you deal with the foreign exchange components on the underlying hedged item?

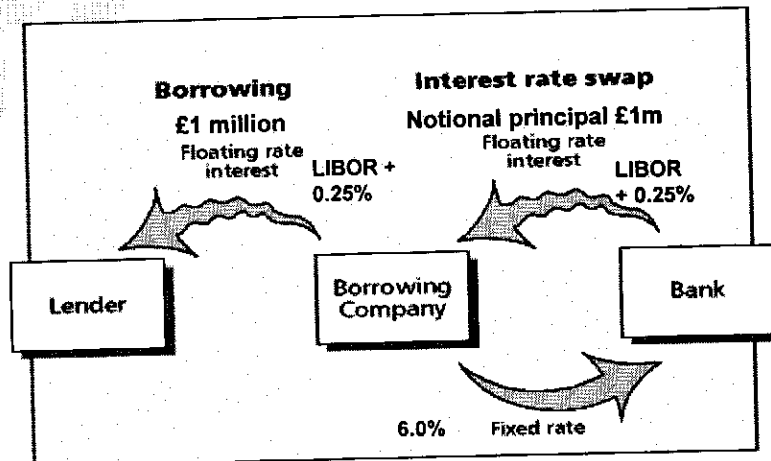
Tax Issues (2)

- What is the tax treatment of the option on 1 March?
 - Exercise of the option and gains on the options contract
 - What if the option lapses?
- Hedging rules to deal with the underlying hedged item?
 - If so, what are the advantages and disadvantages of these rules?
 - If not, how to ensure consistency of treatment?
- What is the treatment for the option grantor at the same time? Is the treatment different if the option grantor is a trader in this type of options?

COMMON DFIs - SWAPS

- Swap
 - Exchange of income streams, calculated with reference to changes in value of some underlying subject matter (interest rate, foreign currency, shares etc)
- Largest markets are in:
 - » interest rate swaps
 - » currency swaps
 - » commodity swaps (for agriculture and mining)
 - » credit swaps
- Idea is to shift / accept risk on one transaction for a similar transaction - alter risk profile

Example 1 - interest rate swap



OECD  OCDE

Interest rate swap

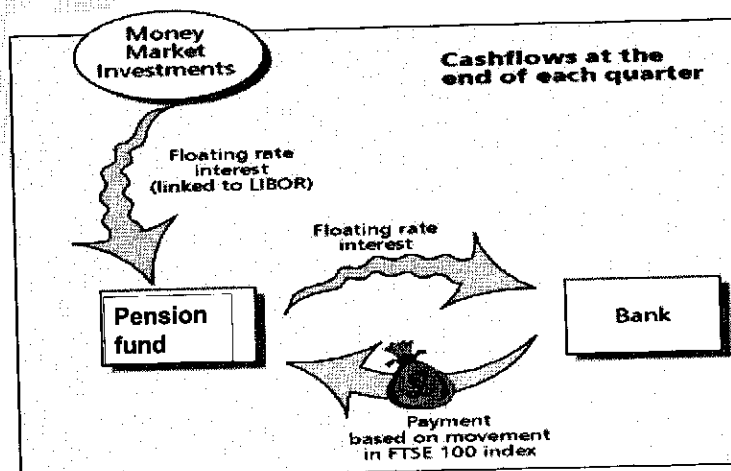
- Periodic payments exchanged at agreed intervals, e.g. quarterly. Amounts normally netted off - if LIBOR is say 4.75%, bank pays £12,500, company pays £15,000; therefore company pays net £2,500.
- Company may pay or receive lump sum if swap is terminated prematurely, or assigned
- Company has fixed the cost of its borrowing - no longer exposed to interest rate risk
- May be cheaper than issuing a fixed-rate bond

OECD  OCDE

Swaps - example 2

- A pension fund invests both in equities and in debt instruments. It wants to reduce its exposure to interest rates, but increase its exposure to UK share prices.
- **Equity swap** is one way of doing this
- **Advantages**
 - reduction in transaction costs
 - flexibility: easier to respond to market changes

Example 2 - equity swap



Tax Issues

- Does the character of swap payments depend on the underlying subject matter of the swap? e.g. interest or foreign currency payments.
 - If the payments were made across border, how do you characterise them for treaty purposes?
- Are gains and losses under interest rate swaps taxable or deductible for tax purposes? On every balance date? On realisation?
- If taxable/deductible at every balance date (i.e. before the swap payments are made), what methods are used to calculate the amount that should be brought to tax?

Tax Issue

- Would your answers be different if the arrangement is a zero coupon swap (i.e. only include a lump sum, fixed rate payment at the end of the contract)?
- Are payments made under the swap arrangements subject to withholding taxes?


Summary of Taxation Issues

- Overall Objectives of Tax Rules:
 - Eliminate artificial tax barriers
 - Reduce potential tax arbitrage opportunities
 - Keep compliance costs in check
- Characterisation issues: debt and debt substitutes; revenue or capital; characterisation under treaty articles
- Timing rules: yield to maturity, mark to market, straight line and realisation/cash basis
- Withholding taxes?
- Avoidance: synthetic loans and other arrangements
 - Policy issues and arbitrage/avoidance issues will be discussed in detail later



Taxation of Financial Markets

13 - Taxation of Banks (International Issues)



International tax Aspects

- Arbitrage between different tax rules
- Withholding taxes/ foreign credits
- Off shore banking centres
- Taxing subsidiaries of banks
- Taxing Permanent Establishments

Source Based Income Taxes

- Imposed on income from financial activities of non-residents
 - Interests and Dividends
- Rationale
- OECD Model Tax Convention
 - Article 11: Interests
 - Article 10: Dividends
- Avoidance problems
 - Conduits and Treaty Shopping
 - Special Issues with Dividend

OECD  OCDE

Withholding taxes

Non banks		Banks	
● Resident State		Interest Received	100
Interest Received	100	Interest Paid	98
Tax Rate 30%	30	Profit	2
● Source State		Tax at 30%	0.6
Interest Paid	100		
Withholding Tax	10	Withholding tax	(10)
● Relief		Loss of	8
Tax in Resident	30		
Tax Credit	(10)		

OECD  OCDE

Withholding taxes

- **Issues**

- Bank makes a loss of (8)
 - Won't lend
 - Passes cost on to borrower (increased cost of finance)
 - Avoids withholding tax
- Resident state
 - No tax on transaction
 - Possible loss of 9.4 tax

- **What do your countries do if you were resident state here?**

- **Source state?**

Foreign Tax Credits

- **When banks are taxed on world-wide income, taxes paid overseas will be given as foreign tax credits**
 - calculate tax as usual
 - less, foreign tax credits arising from withholding taxes and/or taxes on underlying corporate profits
- **Common techniques to maximise use of foreign tax credits**
 - book loans with high withholding tax in jurisdictions with low income tax
 - Use provision for bad debts and other discretions to smooth income

Offshore Banking Units and Offshore Booking Centres

- Offshore banking units exist in many countries to carry out banking activities
 - aimed at attracting offshore clients
 - usually subject to strict regulatory control and are not available to domestic clients
 - favorable tax treatment such as exemption from income tax and withholding tax on interest paid to offshore persons
- Can be used to avoid taxes in other countries
- Offshore booking centres and service fee models used by financial dealers

Subsidiaries and Permanent Establishments

- Subsidiary legally a separate entity from parent
- PE is not a legally separate entity
- Commercial reasons for choosing to trade through a permanent establishment rather than subsidiary
 - Regulatory
 - Credit rating and cost of borrowing
 - Other economies of scale
- Tax consequences for parent company state
 - Profits – taxable only when dividends paid
 - Losses – not relieviable

Source State Taxing Rights Subsidiaries and PEs

- For source state to have taxing rights there needs to be a permanent establishment or subsidiary
- Article 5 sets out conditions that create PE
 - Business carried out through fixed place of business
 - Or dependent agent
 - Representative offices
- Article 7 attributes profits to PE
- Article 9 determines profits between associated enterprises

OECD  OCDE

Source state taxing rights Representative Offices and PEs

- OECD Model Convention
 - PE taxed as separate entity : Business Profits
 - Otherwise: Withholding taxes
- PE arises when the business is conducted through a fixed place of activity or through a dependent agent - See OECD Model Convention for details
- Representative offices of banks
 - difficult to determine whether it should be subject to tax as a PE
 - ability to conclude loan contracts, or simply gathering information necessary for making loans from the offshore parent bank?

OECD  OCDE

Taxing International Businesses of Banks and Financial Dealers

- Article 9 issues (associated enterprises)
 - Recognition and Valuation of transferred loans
 - Allocation of head office administrative costs
 - Allocation of profits in global dealing (though often PEs)
- Deduction of financing/interest costs
 - Thin capitalisation often not a big issue between associated enterprises – source country banking regulator
 - Interest rates, guarantee fees, unnecessary subordinated debt
- Foreign tax credits
- Offshore banking units and offshore booking centres

OECD  OCDE

Recent OECD work of relevance to banks and financial dealers

- Report on Attribution of Profits to Permanent Establishments July 2008
 - Part I General
 - Part II Traditional Banking
 - Part III Global Trading
 - Part IV Insurance

OECD  OCDE

Implementation: How do we get changes in place?

- Implementation package to reflect a two-track approach:
 - Implement full AOA through new text for Model Article 7, with new Commentary
 - Also prepare new Commentary for *existing* Model Article 7, importing as much as possible of AOA as does not conflict with existing Commentary
- Objective – to provide maximum legal certainty for interpretation of existing and new treaties

Attributing Profits to PEs

- **Authorised OECD Approach (AOA)**
- The authorised OECD approach contains 2 steps:
 - Hypothesise the PE as a separate and distinct enterprise. Attribute to the PE functions, transactions / contracts with third parties, assets, risks, free capital.
 - Apply the arm's length principle and TP Guidelines by analogy to the "dealings" recognised between the PE and other parts of the enterprise it belongs to.

Attributing Profits to PEs

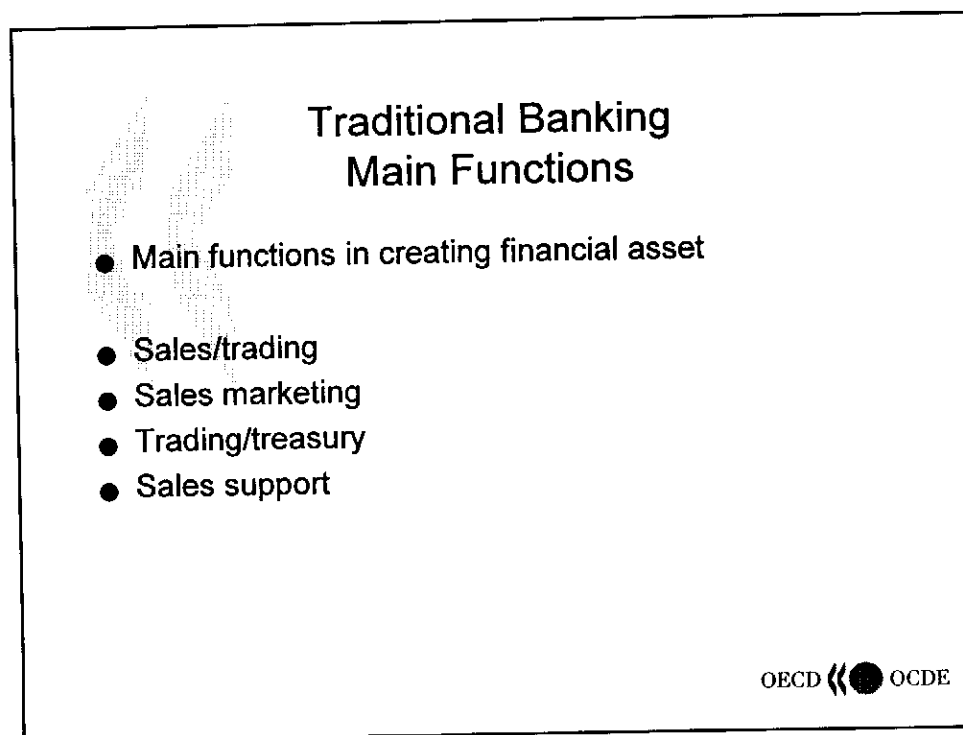
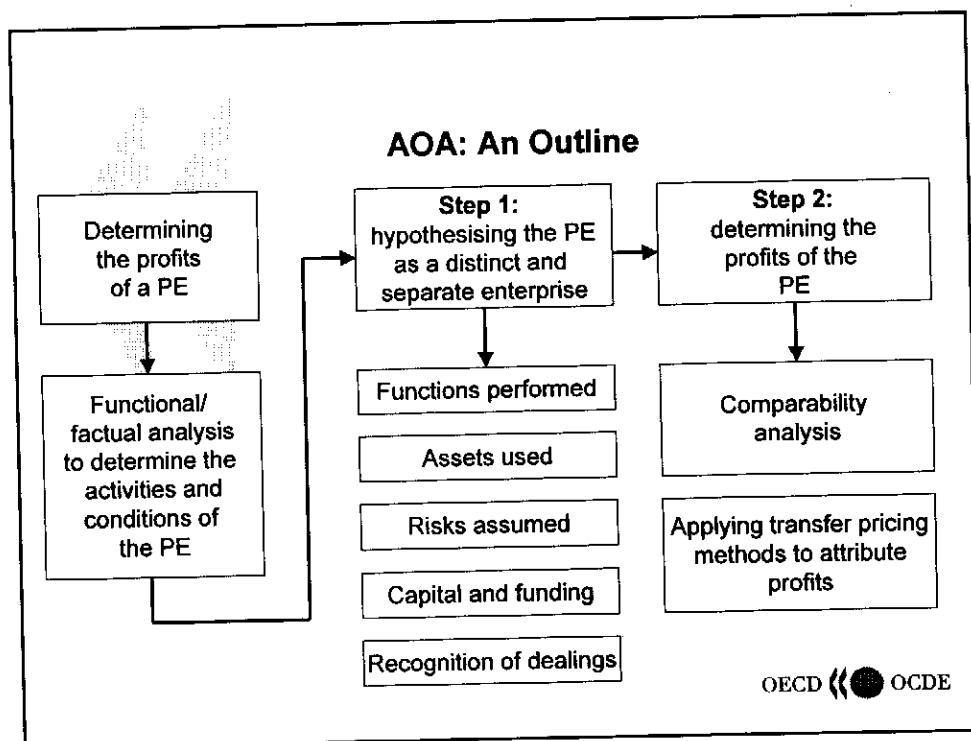
- Step one

- Attribute to PE rights and obligations arising between enterprise of which PE is a part and separate enterprises
- Determine functions of PE and economically relevant characteristics relating to these functions
- Attribute risks to PE based on "key entrepreneurial risk taking functions" (KERT)
- Attribute economic ownership of assets among different parts of enterprise based on KERTs
- Recognise and determine "dealings" between PE and other parts of enterprise
- Attribute capital based on assets and risks

Attributing Profits to PEs

- Step Two

- The dealings between the PE and the rest of the enterprise
 - compared to transactions of independent enterprises
 - Performing same or similar functions
 - Using same or similar assets
 - Assuming same or similar risks
 - Possessing same or similar economically relevant characteristics
- i.e Apply 1995 Transfer Pricing Guidelines by analogy



Traditional Banking Main Functions

- Main functions in managing an asset
- Loan support
- Monitoring Risks
- Managing Risks
- Treasury
- Sales/trading – deciding to sell/securitise loans

Traditional Banking “KERT” Functions

- KERT functions
 - “those which require *active decision making* with regard to acceptance and management of ... individual risks
- Depends from bank to bank but likely to be
 - Creation of asset and subsequent management of risk
- Sales/trading function
- Risk management function
- But
 - Could be sales marketing in certain retail banks
 - Could be function of negotiating loan terms

Traditional Banking "KERT" Functions

- Role of committees setting overall risk limits for the bank
 - Generally not KERT function
 - Set parameters but do not perform the functions that create the asset
 - Do not require : "active decision making with regard to ... individual risks and portfolios of risks"

Traditional Banking Transfer of risks/assets

- Between associated enterprises risks and assets can be allocated by legal contract
- Between one part of enterprise and another part of same enterprise need
- "real and identifiable event"
- "change in functions relating to the financial asset"
- A simple book entry transferring loan or risk from one part to another is not sufficient.



Traditional Banking Main risks

- Credit risk
- Market interest risk
- Market foreign exchange risk



Global Trading

- Term Global trading
 - Refers primarily to market making on a global or 24 hour basis
 - And broking or dealing businesses where business is conducted in more than one place



Global Trading Main Functions

- Sales/marketing
- Trading
 - Market making
 - Risk management
- Treasury
- Support
- Strategic risk management functions



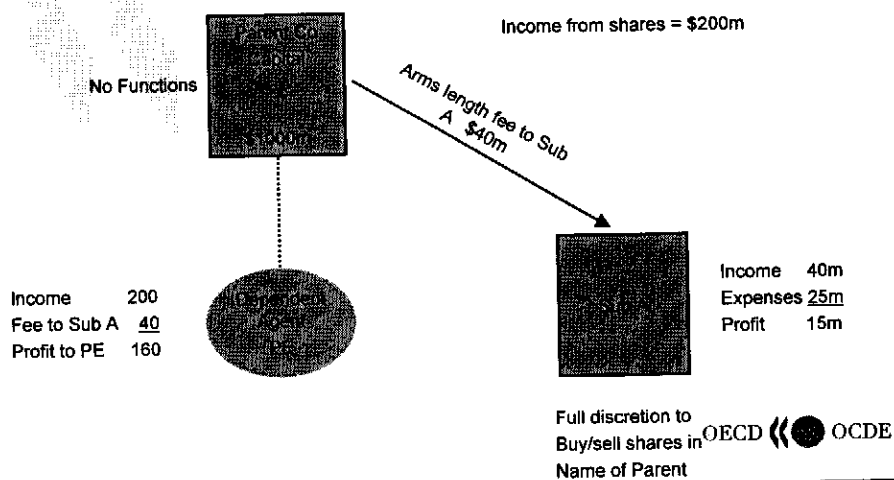
Global Trading KERT Functions

- Depends form bank to bank but
- Trading and Market risk management function is likely to be of particular importance
- But could also be marketing function for highly specialised products were marketer may be involved in structuring the product

Global Trading Main risks

- Market risk
- Credit risk
- Organisational models
 - Centralised product management
 - Separate enterprise model
 - Integrated trading model
- In practice may not be neat distinctions between categories, look behind the labels.

Example 1



Example 2

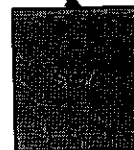
Traders make buy/sell decisions.

Income 200
Fee to Sub A 10
Profit to HQ 190



Income from shares = \$200m

Arms length fee to Sub A \$10m



Income 10m
Expenses 7m
Profit 3m

Executes buy/sell
Decisions of
parent

OECD  OCDE

Attribution of Capital

- Capital allocation
- Economic capital allocation approach
- Thin capitalisation
- Safe harbour approach

OECD  OCDE