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International tax issues arising from the use of derivatives

(and examples of Structured Finance products)

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Derivatives

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What is a derivative?

- A financial instrument, traded on or off an exchange, the price of which is directly dependent upon the value of one or more **underlying** securities, equity indices, debt instruments, commodities, other derivative instruments, **or** any agreed upon pricing index or arrangement. Derivatives involve the trading of rights or obligations based on the underlying product but **do not** directly **transfer property**.
- They are used to hedge risk or to exchange a floating rate of return for a fixed rate of return.

Concepts

- Derivatives include
  - – Exchange traded options and forward contracts
  - – Non-exchange-traded options and forwards
  - – Futures
  - – Swaps
    - » Interest rate swaps
    - » Credit default swaps
    - » Currency swaps
    - » Equity swaps
  - – And many variations thereof.

Specific tax issues – domestic law

- Character of income & expense
- Deductibility of expenses
- Timing of taxation of income & expenses
- Source of income
- Withholding tax at source
- Application of anti-avoidance rules
- Financial instrument A may be made up of components B+C - but tax treatment of A may not be same as tax treatment of B and C when they are considered separately

Treaty issues

- Characterization in source country – which Article?
  - Art. 7 - Business Profits
  - Art. 10 – Dividend
  - Art. 11 - Interest
  - Art. 13 - Capital Gains
  - Art. 21 - Other Income
- Timing issues
- Double tax relief in residence country

Treaty issues

- Tax treaties limit WHT on payments under derivatives
- Income under a derivative most commonly classified as business income, capital gain or other income
- Under Art. 7, 13 or 21, the income is taxable only in residence country
  - Unless PE in source country
  - NB "Other income": Many treaties provide that it may be also taxed in the source country

Interest rate swaps

- Payments under the swap are determined with reference to amount of interest
- However, the swap payments are not actually interest
- No loan between the parties – thus cannot be a debt claim
  - OECD Commentary – reference to substance over form rules in domestic law

Art. 11 - Interest

- For it to be interest under Article 11 there must be a “debt claim”
- A swap can be an in-substance loan
- An interest element can be embedded in swap
- Issue: whether tax treaties will treat this interest element as interest
- Generally accepted source-country view – not interest but business profits
- But …

Art 11. OECD Model Commentary

- Paragraph 21.1 of Commentary to Art. 11
  - "the definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kind of non traditional financial instruments where there is no underlying debt (for example interest rate swaps).

    However, the definition will apply to the extent that a loan is considered to exist under a 'substance over form' rule, an abuse of rights' principle, or any similar doctrine…"

Art 11. OECD Model Commentary

- But is it so easy to conclude that there is a debt claim when in reality there is no debt claim?
- Larger issue:
  - No actual debt claim
  - But using substance-over-form or other anti-avoidance rule, tax authorities consider there to be a debt claim
  - But if domestic law is silent on this issue, i.e., the term “debt claim” is not known in domestic law
  - Then: As “debt claim” term not defined in the treaty and Article 3(2) allows domestic law to apply – can one simply invent a domestic law meaning - create a meaning for “debt claim”?

Art 11. OECD Model Commentary

- Or, is there an international tax law meaning of debt claim which in the context of Article 11 prevents one from simply giving it a convenient meaning via Article 3(2)?
- "Convenient meaning" refers to the meaning that the assessing officer would like it to have
- Same issue arises with many treaty terms, including "beneficial ownership"

Treaty override

- Greece, Mexico impose WHT on derivatives
- Singapore regards interest rate and currency swaps as payments in connection with indebtedness
- This approach is not approved by tax treaties
- Payments are analogous to interest but not covered by Article 11

Forward contracts

- Currency forward contracts
  - payments under forward contracts are not interest
  - But business profits
  - Thus no WHT

Swaps

- Avoidance of WHT
  - Equity swap agreement
    - » Converting cross border dividend payment to local dividends
    - » Avoiding payment of WHT on dividend
  - Loan swap
    - » Make upfront payment to resident
    - » Series of repayments to non-resident under swap
    - » If transaction respected as swap – interest WHT may be avoided

Original Issue Discount (OID)

- Example: Bond issued at 90, but face value of 100, term of 5 years.
- Issue: source (paying) country withhold on day one, on accruals basis or on maturity?
  - Day one – Italy levies WHT on the 10 when the 90 is paid to the borrower
  - Accruals basis: WHT applies on the annual amount (2 in this case)
  - On maturity – the payment of the 100
- Does payment at maturity constitute interest?
  - Domestic law definition relevant
  - For tax treaties, as per OECD Commentary – OID payment may be interest

Original Issue Discount (OID)

- Withholding, if it exists, typically only on payment to non-residents
- If OID subject to WHT only on maturity, WHT may be avoided by selling the bond to a resident before maturity (assuming no WHT between residents)

Some Structured Finance Examples

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Repos

Sale and Repurchase (Repo) over shares in SPV for 5 years

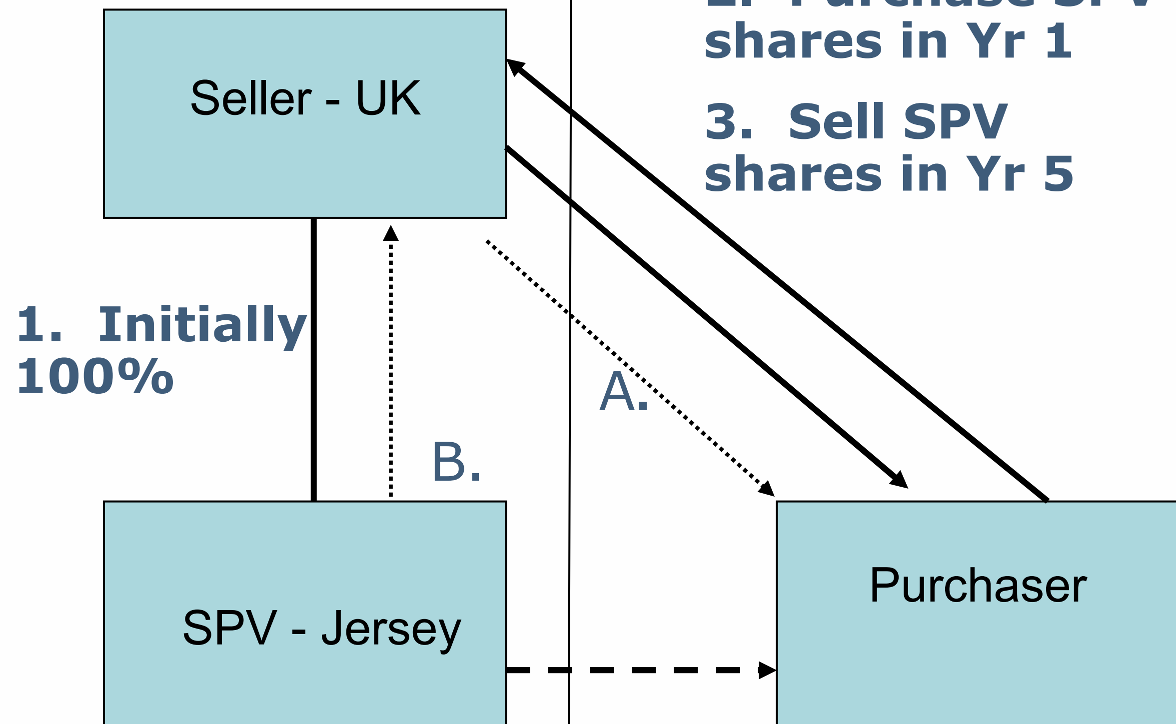
In UK:

Deemed interest deduction for UK seller - A.

Deemed manufactured dividends received by UK investment seller generally exempt - B.

In Country B:

Dividend may be exempt



Repos

- Repos: financial arrangements where securities are **sold**, and also **repurchased** at a later date at pre-agreed prices.
- The **cross border** sale and repurchase (repo) structure is based on tax arbitrage between deductible interest in the borrower country and tax exempt dividends in the investor country.
- Seller receives cash; purchaser gets securities for the period of the transaction.
- Is an in-substance lending, with security to the lender being securities which they hold for the term of the transaction, or can on sell.

Repos

- Repo differs from a stock lending arrangement where there is generally no purchase or sale price.
- The cross border repo requires the borrowing country tax system to treat distributions as deductible, and this generally requires a **substance over form** treatment where the whole transaction is treated as an **in substance borrowing**.
- The cross border repo also requires the investing country tax system to treat the investment as exempt, and this generally requires a **legal approach** where a specific tax exemption applies to the dividends.

Repos

- The repo requires the borrowing company's country to treat the repo arrangement as an in substance borrowing.
- This treatment applies where that country looks at the economic substance of the transaction, where cash is borrowed for the term of the transaction, and securities are provided for the term of the transaction.
- The dividends paid on SPV shares are recharacterised as interest paid by the original parent company in return for the use of the borrowed funds.

Repos

- The repo also requires the distribution to be treated as tax exempt in the hands of the investor / purchaser.
- This usually applies where there is a participation exemption, where dividends from sufficient interest in another company is fully or partially exempt from tax.
- The participation exemption is common in European countries.

Repo Deduction

US (1)

- The US can be an effective jurisdiction under the cross border repo structure for a US entity as a borrower.
- The entity selling the securities and later repurchasing them is generally treated as paying interest.
- No gain or loss is recognised on the exchange of securities, or on the exchange of rights under such agreement by that taxpayer for securities identical securities

Repo Deduction

US (2)

- The agreement is required to provide for the return to the transferor of securities identical to the securities transferred;
- Payments are to be made to the transferor of amounts equivalent to all interest, dividends, and other distributions which the owner of the securities is entitled to receive during the period; and
- There should be no reduction of the risk of loss or opportunity for gain of the transferor of the securities in the securities transferred.

Repo Deduction

UK (1)

- The UK can be a borrower, obtaining deemed interest deductions, under the cross border repo structure. The transaction is recharacterised as a secured borrowing by the repo seller.
- The repo buyer (temporarily acquiring the securities) is deemed to have made a loan to the repo seller equal to the amount initially paid for the securities by the repo seller.
- During the term of this loan the repo buyer receives any dividends on the shares, as the registered holder.

Repo Deduction

UK (2)

- The repo seller is deemed to pay interest to the repo buyer on its borrowing. The repo buyer is deemed to derive the interest income.
- The repo buyer is deemed to pay a manufactured dividend to the repo seller equal to the dividend it receives. The manufactured dividend is deemed to be derived by the repo seller, and retains the characteristics of the underlying actual dividend.

Repos/Exempt Income

Country List

Country	Role	Treatment
US	Borrower	Allows deduction as in substance loan
UK	Borrow/ Invest	Allows deduction as repo buyer is a deemed borrower
Germany	Investor	Allows exempt income
France	Investor	Allows exempt income
Netherlands	Investor	Allows exempt income
Luxembourg	Investor	Allows exempt income
Italy	Investor	Allows exempt income
Sweden	Investor	Allows exempt income
Switzerland	Investor	Allows exempt income
Denmark	Investor	Allows exempt income
Australia	Investor/ Borrower	Allows exempt income, Can also allow deduction if non contingent

Domestic Tax Paid Structure

Partner A

Partner B (nominal)

6.Distribution **41**

1. Equity-coupon

Country A

Australia

OpCo

2. Loan-convertible

LLP

Tax Office

4. Tax Paid 18

5. Interest 41

3. Income 100

Investments

Country A - LLP is a partnership.

Australia - LLP is a corporate

Domestic Tax Paid

- Countries A and B both allow credit for tax paid by LLP.
- Countries A and B do not recognise all the income in LLP, as each allows deduction of 41.
- Country A treats Loan payments on convertible notes to OpCo as interest.
- Country B treats distributions to A on the partnership interest to Partners A and B as interest due to the coupon.

Domestic Tax Paid

- Without the structure, tax on 100 at 30% is 30.
- With the structure, tax on 59 at 30% is 18.
- The net benefit of 12 is the additional deduction of 41 times the tax rate of 30%.
- The result is that A and B investors each receive 41 after tax, not 35 without the structure.

Foreign Tax Credit - US Tax Paid

Partner A

Partner B (Nominal)

5. Distributions 40

1. A Units, Put and Call to USCo

Country A

USA

OpCo

2. B Units

Delaware Partnership

IRS

4. Tax Paid 20

5. Distributions 40

X

3. Income 100

Investments

Country A and US allow credit for tax paid by DP

USA does not recognise all income in DP - it allows a deduction for A Unit distributions due to Put and Call

Country A treats DP as a partnership

US checks the box, treats DP as a corporate

Foreign Tax Credit - US Tax Paid

- The Delaware general partnership tax paid structure is based on an entity paying tax which is creditable in two countries.
- The partnership derives taxable income, and pays US tax which is creditable by the partner in the partners country as well as by the USCo in the US.
- The partnership income is not fully taxable in the US, because A unit distributions are treated as deductible in the US due to the put and call resulting in A units being treated as an in substance loan.

Foreign Tax Credit - US Tax Paid

- No US interest withholding tax applies, due to the Portfolio Interest Exemption, or under treaty exemptions.
- This applies where Partner A has less than 10% voting in the Delaware Partnership
- In addition, Partner A is not a bank (or agent of a bank), does not become a bank and does not undertake any banking types of activity.

That's about it. Thanks and enjoy the rest of the Conference

Comments and questions very welcome
- see first slide for contact details.

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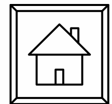

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