

The Taxation of Financial Transactions¹

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Generations of TOFT rules

- 1st generation rules date back half a century and dealt with fundamental building blocks
- 2nd generation rules looked beyond form to economic substance
- 3rd generation rules

1st Generation Rules

1st generation financial transaction rules addressed three issues:

- debt-equity distinction
 - thin capitalisation
 - debt dividends
 - early hybrids
- character of interest substitutions
- recognition timing for basic interest substitutions

2nd Generation Rules

2nd generation rules looked beyond form to economic substance:

- sale/loan transactions disguised as leases
- embedded debt

3rd Generation Rules

3rd generation rules deal with modern transactions:

- options,
- hedges,
- synthetic arrangements,
- repos,
- debt defeasance
- dissected debt
- etc.

1st Generation: Debt-Equity

Early debt-equity distinction issues arose in three areas:

- thin capitalisation
- debt dividends
- early hybrids

Thin capitalisation

- accounting and legal distinction between debt and equity imported into tax law
- generally, interest on debt is deductible and dividends on equity is not
- in some countries relative neutrality achieved through imputation, exemptions, or split rates
- but in all countries differences remain, leading to two sets of rules

Thin capitalisation (cont.)

- in classical company-shareholder tax systems thin cap important for all investors
- in imputation systems important for non-residents
- thin cap rules treat excessive debt as equity (no deduction for interest on excessive debt)
- may only apply to debt to related persons

Early hybrids

- convertible notes take the form of debt convertible to equity
- since the conversion cost is set at the time debt is issued, investor realises all the benefits of equity investor
- hybrid rules treat convertible debt as equity (no deduction for interest)

Debt Dividends

- many jurisdictions provide an exemption for inter-corporate dividends
- financial institutions substituted redeemable preference shares for debt
- “debt dividend” rules recharacterize the dividends as interest or exclude the dividends from the exemption

1st Generation: Interest substitutes

What determines the interest rate?

- underlying interest rate
- current and projected inflation
- risk
- magnitude of loan
- time to repayment

What forms can a loan take?

- interest only loans
- blended payment (amortising loans)
- single payment loans
 - compound interest
 - discount or premiums
- any combination of the above

Character of the gain

- first issue with interest substitute such as a discount is the character of the gain
- mostly a problem in anglo jurisdictions which adopted the UK trust law distinction between “capital gains” and “ordinary income”
- unless gain was entirely discount, courts might treat discount part as exempt or lightly taxed capital gain

1st Generation: Time of recognition

- need for recharacterisation only arose in anglo jurisdictions
- need for timing rules arose in many more
- economically, all types of loans are similar but a small number of jurisdictions allowed taxpayers to defer recognition of compound interest and more jurisdictions did so for discounts
- timing rules now require annual recognition on yield to maturity basis

2nd Generation Rules

2nd generation rules looked beyond form to economic substance:

- embedded debt
- sale/loan transactions disguised as leases

2nd Generation: Embedded debt

- most common example of embedded debt is an instalment sale
- asset costs 100 and market value is 200 but vendor agrees to sell for 450, payable 45 per year for 10 years
- it is clear that more than half the amount received is interest for the credit extended, not gain on the sale of property

Embedded debt (cont. 2)

- vendor sells for 200; purchaser borrows 200 from a bank, repayable \$45 x 10 yrs
- vendor sells for 200; lends purchaser 200, repayable \$45 x 10 yrs
- vendor sells for 450, payment \$45 x 10 yrs, no interest for deferred payment

Embedded debt (cont. 3)

- when to recognise gain on the asset sale and embedded debt?
 - option 1: pro-rata over the payments ($45 - 10 = 25$ per year)
 - option 2: upfront $200 - 100 = 100$ and then blended payment loan (part interest, part principal)

Embedded debt (cont. 4)

- asset cost 100, sold in 2006 for \$600, payable in 10 years time
- asset cost 100, sold in 2006 for \$200; vendor lends purchaser \$200 on compound interest loan maturing in 10 yrs
- asset cost 100, sold in 2006 for purchaser's house, to be transferred in 2016

2nd Generation: Finance lease

- Finance lease is structured as a rental agreement – lessee rents substantial equipment for a fixed period and is then allowed to purchase for small residual value
- but all the essential attributes of ownership transfer from the “lessor” to the “lessee”; in economic terms it is a sale to the lessee and a loan

- accounting principles treat as a loan and dissect each payment into principal and interest
- many tax laws now follow accounting principles and treat finance leases similarly

3rd Generation Rules

3rd generation rules deal with modern transactions:

- repos,
- options,
- hedges,
- synthetic arrangements,
- debt defeasance
- dissected loans
- etc.

3rd Generation: Repos

- some synthetic arrangements such as repos replicate pure discounted debt
- repo is a “purchase-repurchase” arrangement:
e.g.: “borrower” sells an asset to a bank and provides a put option obligating it to repurchase the asset after 180 days for the original cost plus premium based on LIBOR + 3%

- individual elements do not reveal debt but taken in its entirety, the transaction is nothing more than an ordinary securitised loan with all the loan elements dissected into separate transactions
- legislation or judicial concepts treat this as a loan

3rd Generation: Dissected debt

- lend 100 for 10 years @ 10% interest
- payments are:
 - 10 per year for 10 years; and
 - 100 in 10 years
- what is the total value today for the right to 10 payments of 10 and the right to 100 in 10 years time?

- total value today of the future payments is 100 as that's what I've paid for the two rights
- both rights will pay 100 but in the case of interest, I get 10 a year each year while in the case of principal, I have to wait 10 years
- if the present value of the interest stream is 60, what is the present value of the right to principal?

- debt dissection rules treat me as having sold the entire debt for the original cost and repurchased the two rights as separate assets
- this is the cost base if I sell one right – for example, retain the right to principal and sell the right to interest

3rd Generation: Debt defeasance

- borrower pays another person to take over part of its debt obligation (e.g., obligation to pay annual interest or obligation to pay principal in 10 years)
- same rule should apply as in debt dissection – disposal for original proceeds and reacquisition of two separate liabilities with the proceeds pro-rated

3rd Generation: Hedges

- a pure hedge transaction is an offset transaction that should wash out for tax purposes apart from the cost of the hedge
- e.g., Thai baht customer purchased machine priced in foreign currency of 40 and has 30 days to pay.
- Buyer calculates the cost as 1000 baht at today's rate. Rather than buy forex now, buyer acquires an option to buy 1000 baht for 40 in foreign currency

- the two sides of a hedge will always wash out, leaving the underlying gain or loss.
- to ensure the correct result, both sides should be recognised using the same timing rules
- normally “fair value” accounting or “mark to market” accounting

3rd Generation: Program for reform

- modern instruments take on a wide variety of forms – synthetics, swaps, hybrids, etc.
- however, all arrangements are either a loan or a bet or a combination of the two.
- all combined instruments and arrangements can be dissected the component parts with loans recognised on an accrual basis and bets on a realisation basis