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TAXeNEWS Financial Services

Taxation of Derivative Financial Instruments

On 28 January 2002 the Federal Tax Administration (EstV) issued the second edition of Appendix III to Circular No.4 dated 12 April 1999 concerning the taxation of Bonds and Derivative Financial Instruments for Direct Federal Tax, Withholding Tax and Stamp Duty purposes.

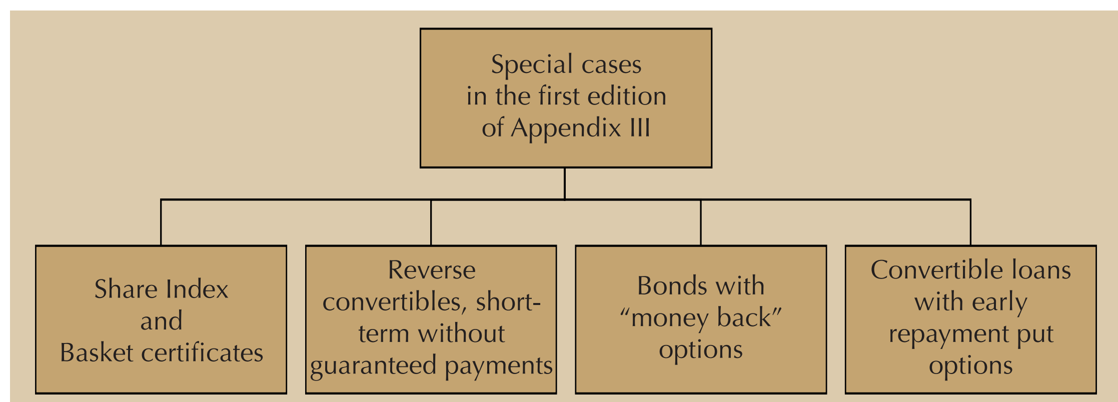
2002/1

The new tax rules clarify matters

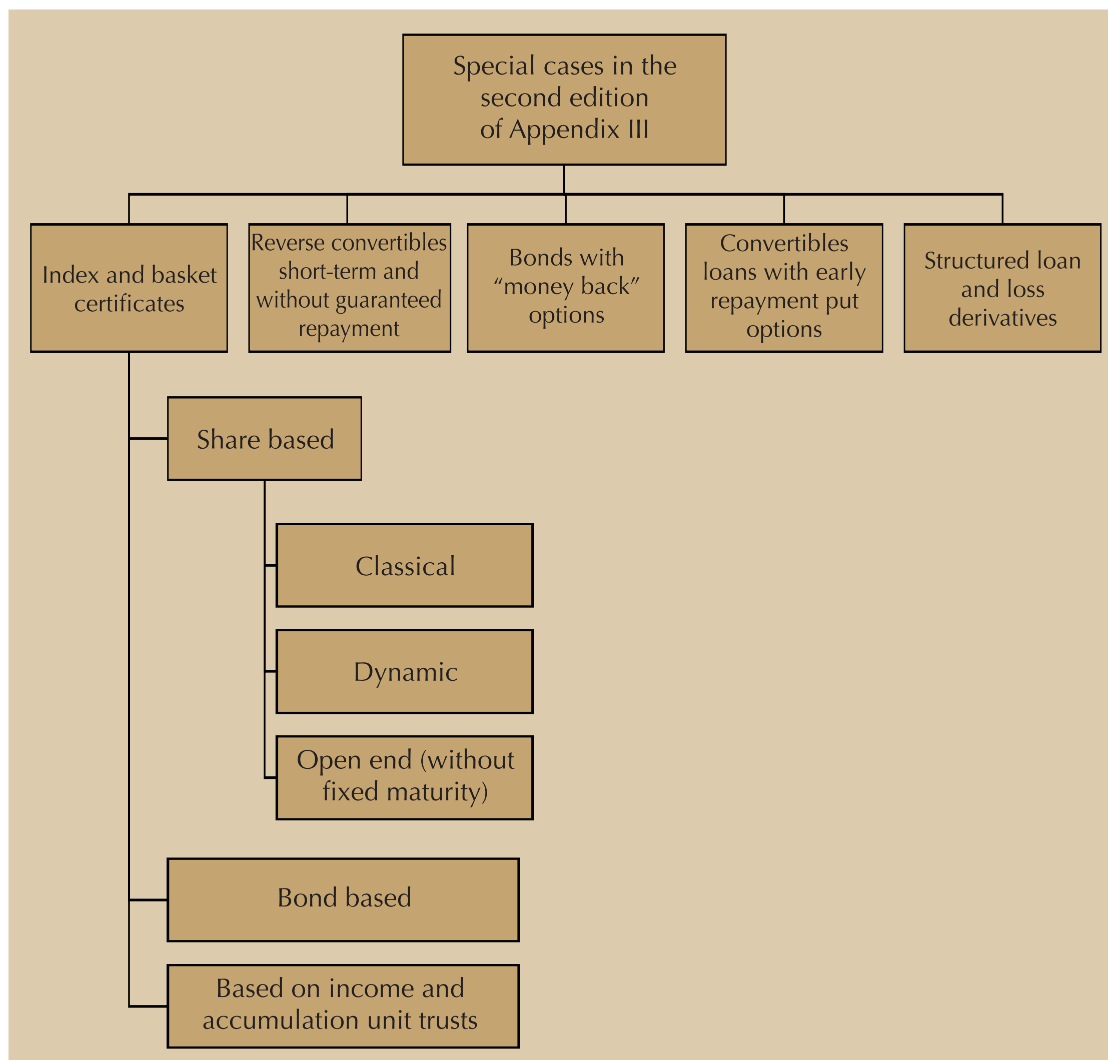
The intention of the 1999 Circular is to provide guidelines for distinguishing between tax-free capital gains and taxable investment income of individuals from bonds and derivative financial instruments. In this sense the Circular distinguishes between the tax treatment of income from bonds, from derivative financial instruments and from combined derivative financial products. The tax treatment of innovative special products is not covered by the more general comments in the Circular. This purpose is fulfilled explicitly by Appendix III, which is to be updated regularly in line with developments in this field. With the second edition of Appendix III dated 28 January 2002 it has been adapted for the first time to take account of developments in the financial markets. In addition the EstV has clarified some questions and changed its practice in others.

Review of the significant changes and additions

The first edition of Appendix III to Circular 4/1999 listed as special cases the index and basket certificates, the reverse convertibles known as BLOC, TORO etc., bonds with "money back" options and also convertible loans with early repayment put options.



In the second edition the EstV has for the first time made a narrower classification of the index and basket certificates. Whereas in the first edition only share-based certificates were dealt with, certificates based on shares, on bonds and on unit trusts (mutual funds) are now distinguished. Furthermore the share-based certificates are broken down into classical, dynamic and so-called open-end basket and index certificates. In addition to the special cases set out in the first edition the EstV has also taken up in Appendix III the tax treatment of structured loan and loss derivatives. Further adjustments and additions have also been included in respect of reverse convertibles and also convertible loans with early repayment put options.



The diagram does not list the new special rules in connection with incremental issues of domestic and foreign bonds. These rules are no longer necessary following the abolition at 1 January 2001 of the withholding tax exempt issue discounts of maximum 1/2% per annum of the term (Art. 14 Para. 2 Withholding Tax Ordinance).

Index and Basket Certificates

As already mentioned the new Appendix III to Circular 4/1999 governs the tax treatment of certificates in much more detail than previously. On the one hand the bond and unit trust based certificates have also been considered and on the other the share based certificates have been divided into sub-groups.

Share based Index and Basket Certificates

Share based index and basket certificates are characterised by the fact that economically they represent an investment in the share markets (index certificates) or in baskets of shares (basket certificates) and as a consequence the price of the certificates rises and falls in line with the reference object. Appendix III to Circular 4/1999 distinguishes three types of share certificates with partially different tax consequences:

Classical share based index and basket certificates

The composition of the reference object (share index or basket) of "classical index or basket certificates" remains unchanged throughout the entire term.

From a tax viewpoint gains on disposal of these certificates represent capital gains for the private investor. On the other hand compensatory payments (including an issue discount or repayment premium against the index/basket) are considered to be investment income. Because the issuer of classical basket and index certificates does not guarantee a fixed repayment amount, there is no obligation in the sense of withholding tax or stamp duty law. Therefore withholding tax is not due on the compensatory payments. Issue of and turnover in these certificates are not liable to issue or turnover duty, because the certificates do not constitute taxable deeds. Still ungoverned is the tax treatment of certificates based on individual shares. By analogy with American Depositary Receipts (ADR), depending on the attributes a substitute for the share must be assumed with the corresponding consequences for withholding tax and issue duty (whereby the property of "domestic" would relate to the underlying security). Accordingly in the case of certificates based on individual shares a minimal exercise price (e.g. CHF 0.01) should be foreseen in order that the certificates may be treated as an option (Low Exercise Price Option).

Dynamic share based index and basket certificates

By contrast with classical share based certificates dynamic certificates are characterised by the fact that the securities underlying the certificate are managed i.e. the composition of the index or the basket can change during the term. Despite this management from a tax viewpoint they can continue to be considered as "classical certificates" if the following conditions are cumulatively fulfilled:

- The shares contained in the index or basket are selected and managed according to criteria that are defined precisely in advance (e.g. market capitalisation, P/E ratio etc.).
- The applicable criteria are to be set down in the index or basket specification and may not be altered during the term.
- The indices or baskets established for the purpose of the issue of the certificates are unlimited in time and are registered as a trademark with the competent patent office.

Dynamic certificates i.e. certificates that do not meet the above criteria, are pursuant to Appendix III to Circular 4/1999 in principle treated in the same way as unit trust like assets with the corresponding consequences for Direct Federal Tax and, if appropriate, Withholding Tax (see below on unit trust based certificates).

Open-end share based index and basket certificates

According to Appendix III to Circular 4/1999 open-end share based certificates may be treated as classical or dynamic certificates as explained above, only if the investor is granted a right to give notice annually. The tax treatment of an open-end certificate without right to give notice is not mentioned. In principle in this case also, by analogy with the evaluation of certificates based on individual shares, depending on the attributes a substitute for the shares must be assumed with the corresponding consequences for Direct Federal Tax, Withholding Tax and stamp duty.

Bond based basket certificates

The tax treatment of bond based basket certificates is for the first time explicitly discussed in the Appendix to Circular 4/1999. Because in the case of bond based certificates the certificate owner has the same opportunities and risks as a normal bondholder, bond certificates themselves are treated in the same way as bonds and are therefore by analogy subject for Direct Federal Tax, Withholding Tax and stamp duties to the provisions for the taxation of bonds contained in Circular 4/1999.

Basket certificates based on income and accumulation unit trusts

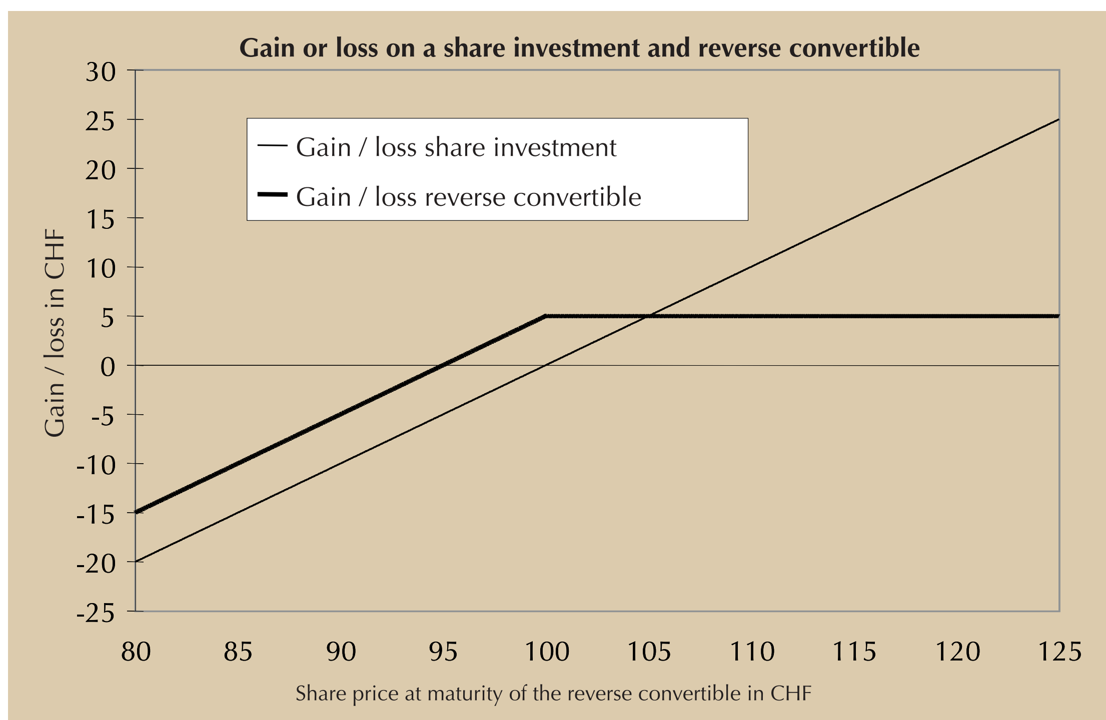
Also newly discussed under the special cases is the tax treatment of revenue from basket certificates based on income and accumulation unit trusts. By analogy with the bond based certificates, here too from an economic point of view reference is made to the tax treatment of the underlying securities i.e. the certificate itself is considered to be a unit trust unit. In consequence the taxation of basket certificates based on income and accumulation unit trusts follows the rules applicable for unit trusts and trust like assets for Direct Federal Tax, Withholding Tax and stamp duties.

Reverse convertibles

The investor in reverse convertible products that are issued in the financial markets under resounding names such as TORO, EROS, BLOC, REVEXUS, receives on maturity either a cash amount, if the share price is above the exercise price, otherwise a share. Economically from the investor’s standpoint it is

- a combination of an investment of capital and the sale of a put option or
- a combination of the purchase of a low exercise price option and the sale of a call option with a higher exercise price “Cap”.

Example
Purchase of a reverse convertible on a share at a price of CHF 95 (price of the underlying share CHF 100). The investor receives a repayment of CHF 100, if the price of the share at the time of repayment is at least CHF 100, otherwise the investor receives a share.



The EstV treats the reverse convertible product basically as a combination of a bond and the sale of a put option. Accordingly a distinction must be made mathematically between an interest component (taxable) and the collection of a put option premium (tax free private capital gain). As long however as the maturity of a reverse convertible is not longer than 1 year, in the EstV's view the share purchase takes priority over the synthetic split between interest and option premium mentioned. Accordingly reverse convertibles with maturities of up to one year are not considered to be bonds and the investor can realise a capital gain.
Basically there has been no change in this view by comparison with the first edition of Appendix III to Circular 4/1999. The only addition is the comment that reverse convertibles such as POWER, BOOSTER, TORERO etc., which in principle fall under the same category, but allow the investor to some extent to benefit twice if the price of the share underlying the product rises, are subject to the same tax treatment.

Convertible loans with early repayment put options

There has been a modification for the issuer in the view on convertible loans with early repayment put options. Whereas in the first edition of Appendix III to Circular 4/1999 the put option had to be considered in connection with the question of one-time interest payments on the investment, now only the bond element benchmarks are decisive.
This change is to be welcomed particularly as it concerns consistency in the system of taxing the interest and risk elements of derivative products.

Structured loan and loss derivatives

Newly discussed under the special cases are the structured loan and loss derivatives. Loan derivatives are financial instruments that transfer the default, rating and the entire spread risk in connection with loans to the investor. By analogy, in the case of loss derivatives, the risk in connection with damage caused by natural catastrophes becomes tradable as a financial product. Basically there is a distinction between structured or combined and pure (non-combined) products. While the non-combined products represent pure derivatives, the structured loan and loss derivatives combine a bond with a futures transaction: the issuer transfers on the one hand the loan or loss risk against appropriate consideration (risk premium) to the investor. At the same time the issuer sells the investor a bond with the same maturity and thereby hedges himself against the default or the damage. If there is no default on the loan or the damage does not occur, the product is equivalent to a normal bond with a right to (enhanced) interest and repayment. If however the defined loan default or damage does occur, the issuer is entitled to transfer the corresponding financial loss to the investor e.g. by not repaying the bond.

For the tax treatment of pure loan and loss derivatives reference is made to the comments on derivative financial instruments in Circular 4/1999. Although Appendix III to Circular 4 /1999 equates both loan and loss derivatives with reverse convertibles in respect of their structure, only loss derivatives are accorded the same tax treatment as the reverse convertibles described above (distinction between tax free risk premium and investment income on the pure interest elements). In the case of loan derivatives the risk premium is equated with the credit risk, which in loan relationships is an element in the interest rate. For this reason it is argued that all income from combined loan derivatives represents taxable investment income. This is not factually correct in that the issuer of the loan derivative has to compensate the investor also for the risk components included in the loan derivative, which under certain circumstances are completely separate from the debt relationship between issuer and investor.

Incremental bond issues

Until 31 December 2001 neither income tax nor Withholding tax was levied on issue discounts of not more than 0.5% p.a. (Bagatelle limit). With the rescission of Art.14 Para. 2 of the Withholding Tax Ordinance this bagatelle limit was abolished without replacement.

In respect of incremental bond issues of bonds first issued under the old law, the abolition of this rule has proved to be problematical because at the time of incremental issues the benchmarks (such as interest rate, term, repayment amount etc.) are taken over from the basic loan. For this reason, at the time of

repayment, it is simply no longer possible to distinguish between a basic loan issued at par and the incremental tranche issued possibly below par. This has the consequence that on repayment withholding tax can no longer be charged to the creditors and the amount has to grossed up. According to Appendix III to Circular 4/1999 therefore for incremental issues of both domestic and foreign loans the abolished bagatelle limit rule will continue to be applied, provided the issue discount on the incremental portion does not exceed 0.5% p.a. for the remaining term.

For foreign loans that because of higher discounts on incremental issues cannot profit from this rule, for practical reasons the weighted average of the issue discounts on the first and subsequent issue(s) will be treated as the tax relevant income when the loan is retired.

Continuing attention is required

The complexity of the rules for taxing structured financial products is extraordinarily great. The new Appendix dated 28 January 2002 to the Federal Tax Administration's Circular No. 4 dated 12 April 1999 has refined the rules already in existence. In addition the new Appendix III has taken into consideration new developments in the financial markets and has provided new rules for the taxation of current products such as dynamic and non-dated certificates, loss derivatives and derivatives based on bonds and unit trusts.

Not only issuers of structured products, but also portfolio managers and investment consultants must be fully conversant with the complex material on the taxation of derivative financial instruments in order that their customers may benefit from an optimal after tax return.

In addition to the tax regulations the supervisory legislation law must also not be ignored. Above all in the field of dynamic certificates and unit trust like products carelessness could lead to stern consequences from the Federal Banking Commission.

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