



# DAUDS ADVISORY

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## Tax

### *Using Derivatives As Tax Planning Tools*

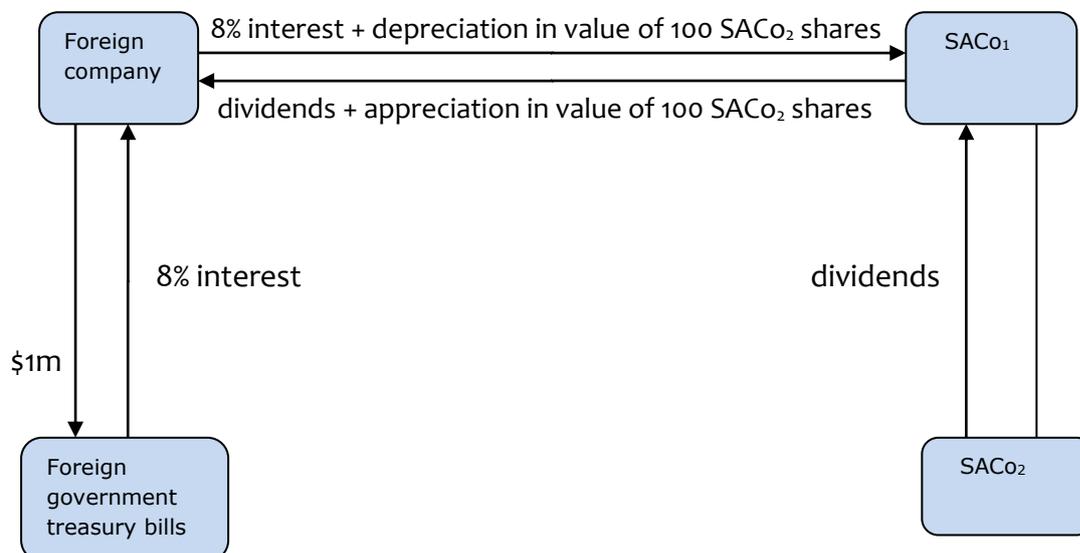
1. New financial instruments, derivatives in particular, have assisted in meeting the global demand for new investment and risk management tools. Derivatives have, for instance, played a very important role in reconciling the different needs of investors and borrowers, and allowed companies to insure themselves against, and thereby reduce, the financial consequences associated with interest and currency movements. In this regard, derivatives have served as a powerful risk management tool. On the investment front, these instruments have similarly made their influence felt by presenting investors with new income-earning opportunities.
2. A derivative may be as simple as an option contract, a forward contract, a futures contract or a swap agreement. It may also become a tad more sophisticated by transforming into what is known, for example, as a total return equity swap which involves the exchange of payments. The use of complex derivative contracts has presented tax authorities with considerable difficulties, especially where these contracts are used in cross-border transactions. That is so because, in accordance with the normal income tax principles, the taxation of an amount is based on its

character, source and timing. Where the amount constitutes a cross-border payment, its taxation will normally depend on the category in which the particular income stream falls, more particularly, whether it constitutes a dividend or interest. Dividends are generally accepted as income derived from the direct investment in the shares of a company, while interest is accepted as income earned from the direct investment in a company by way of, for instance, the purchase of the debt instruments (e.g. bonds) issued by the company. Where the income stream constitutes a cross-border dividend or interest, its taxation is a relatively straightforward matter and guided by the bilateral tax treaty in place or the domestic legislation of the country which is the source of the payment. In these cases, the cross-border payment would be taxed by way of the imposition of a withholding tax on the dividend or the interest at the rates determined by the tax treaty or domestic legislation.

3. However, the traditional systems of categorisation of income streams are becoming increasingly difficult to maintain where sophisticated instruments such as derivatives are used to reflect the economic attributes of investment in diverse forms, thereby modifying the character of the income streams. In this regard, the problems with categorisation can make it particularly difficult for tax authorities to impose a withholding tax on cross-border payments. As a result, the use of derivative contracts may become good tax planning tools and, the more complex the structure of the derivative, the more problematic it may be for the tax authority to identify—
  - the individual beneficiaries of the earnings from the derivative contract;
  - the various contracts that make up the final derivative product;
  - the category of income, i.e. whether it is dividends or interest;
  - the jurisdiction where the income is generated; and
  - the jurisdiction where the parties to the derivative contract are resident.

4. In these cases, the use of derivative contracts makes the categorisation of income for tax purposes irrelevant and unworkable, more so since tax systems tend to treat each component of a derivative product as a stand-alone contract, rather than looking at the derivative in aggregate. This creates an incentive for parties to structure derivative contracts in the most tax-efficient way by, for example, ensuring that withholding tax at source is avoided. For instance, while an amount received as a return on an investment in shares is categorised as a dividend, amounts received in respect of a derivative contract are usually based on what is referred to as “notional principal”. The “dividend” categorisation and the consequent withholding tax may be avoided by structuring a derivative contract in such a manner that the amounts accruing to the parties to the contract replicate the dividends payable in respect of the shares of a company, but are not legally the dividends themselves.
  
5. One of the arguments against subjecting amounts derived from cross-border derivative contracts to any withholding tax is that these contracts do not involve a direct investment in, for example, the shares of a company in respect of which dividends are payable. In other words, there is no inbound investment by any person for that person to be taxed on the return on such investment (e.g. a dividend). Amounts derived from derivative contracts are not distributions of the earnings of a company, nor are those amounts a return on an investment by way of a purchase of the debt instruments (i.e. bonds) of a company. Accordingly, these amounts cannot be subject to tax as though they were distributions of corporate earnings (i.e. dividends) or interest payments on bonds issued by the company.

## Illustration of a cross-border derivative contract



The above is an illustration of a total return equity swap. In the first step, the foreign company purchases \$1m worth of foreign government treasury bills which pay interest at 8% per annum (i.e. \$80,000 p.a.). The foreign company then enters into an agreement in terms whereof it pays a South African company (SACo<sub>1</sub>) the interest it receives on the treasury bills plus the extent of any depreciation in the value of the 100 shares held by that company (SACo<sub>1</sub>) in another South African company (SACo<sub>2</sub>). SACo<sub>1</sub> is thus protected against the decline in value of the shares it holds in SACo<sub>2</sub> in that it will be compensated by the foreign company by way of an amount matching such decline in value. In return, SACo<sub>1</sub> undertakes to pay the foreign company an amount which replicates the dividends payable in respect of the 100 shares SACo<sub>1</sub> holds in SACo<sub>2</sub>, plus the extent of any appreciation in the value of those shares. The foreign company is thus similarly entitled to be paid an amount matching any increase in the value of the shares. As can be seen, the total return equity swap involves, simply, an exchange of payments (i.e. cash flows).

## **Analysis of the SACO<sub>1</sub>/Foreign Company transaction**

6. The foreign company has made no capital investment in any of the two South African companies by way of a purchase of shares in respect of which it earns dividends. What the foreign company has done is enter into an equity swap agreement in terms whereof it swapped its return (interest) on the treasury bills for the return (dividends) of the first South African company's (SACO<sub>1</sub>) investment in the shares of the second South African company (SACO<sub>2</sub>). There is no inbound investment made by the foreign company, nor does it operate a permanent establishment (PE) in South Africa to which the amounts it receives from SACO<sub>1</sub> may be attributed. It would thus be difficult for the South African tax authority to justify subjecting the foreign company to withholding tax on any payments it receives from the South African company with which it concluded the swap agreement — even though what the foreign company has created through the swap agreement is something economically equivalent to purchasing 100 shares in the second South African company (SACO<sub>2</sub>) since it receives the same return as a shareholder, namely, dividends.

## **Suggested approaches to taxing the use of derivative contracts**

7. Various approaches have been suggested to taxing the use of derivative contracts. One approach involves reliance on financial accounting rules, i.e. by making the tax treatment follow the accounting treatment. Another approach advocates bifurcation, i.e. disaggregation, in instances where the derivative is combined with another financial instrument, which may be an equity instrument, a debt instrument or even another derivative. In this case, the disaggregation process aims to isolate and identify the different economic components of the total instrument separately for income tax purposes. Yet another approach advocates the application of broad anti-avoidance measures that involve “substance over form” rules. A fourth approach involves the use of thin capitalisation/transfer pricing rules where the cross-border payment involves seemingly excessive amounts which may have the

effect of diverting corporate earnings to related entities in another tax jurisdiction. Even so, opportunities for the use of derivative contracts in tax planning remain.