TAXATION

OF

FINANCIAL DERIVATIVES

By

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SYNOPSIS

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- Shefali Goradia

INTRODUCTION

Derivatives are primarily risk management tools. More accurately, they are volatility management tools. The ability to assume risk is a function of capital. The basis of the efficient utilization of capital is the netting of risks against each other[1]. Trading in derivatives has now become an integral part of the global financial market. The past three decades have seen a singular rise in the development and growth of derivatives markets the world over. Trading in futures and options has seen a big rise and time and again, new products have been introduced which are related to this concept. Futures, options and OTC derivatives markets are integral parts of almost all economies of the world which have reached an advanced stage of development. Such markets are likely to become important part of developing countries as well, helping them to move to the advanced stage with the passage of time.

The Indian government, based on the L.C. Gupta Committee recommendations, has allowed trading in derivatives to begin in India. The Derivatives Bill, passed recently, will give trading on the domestic bourses a new dimension, as index-based trading would finally be permitted, a long-standing demand in the Indian markets. The shares underlying a stock exchange index would be traded as a single unit. The passing of the Derivatives Bill also requires a change in the definition of 'securities' in the Securities Contract (Regulation) Act (**SCRA**), to include the words 'futures' and 'options'. The development of a derivatives market is considered as a prerequisite for the Indian capital market to be globally competitive.

'Derivative' is an instrument whose value depends on its underlying cash or physical asset. Hence it means that the value is derived from the value of the underlying assets like foreign exchange, currency, securities and commodities. It also includes market indices such as the LIBOR, BSE Sensex or benchmark interest rates. The result of a derivative transaction is a transfer or exchange of specified cash flows at defined future points in time. Derivatives include forward, future and option contracts that are of a pre-determined fixed duration, linked for the purpose of contract fulfillment, to the specified value of real or financial asset or to index of securities.

Derivatives are used to hedge against price, currency and interest rate risk. Since derivative instruments do not involve risks, they help redistribute the risk between market participants. Hence, derivatives in this sense are used for risk management. Derivatives can also be used for speculative functions.

[1] 'The Taxation of Derivatives', British Tax Review, 1998

THE INDIAN LEGAL PERSPECTIVE

Although the focus of the paper is on taxation, it might help to understand some of the legal issues confronting derivative transactions. This section attempts to provide an outline of the legal issues that may arise in a derivative transaction.

Legal issues - legality and validity:

Some of the broad legal issues include exchange control regulations, the issue of legality and validity of the transaction, questions of enforceability, termination provisions and insolvency issues. The Derivatives Bill which was tabled recently in the parliament will remove some of the ambiguities that exist currently in these areas. The Bill is expected to be an enabling legislation with wide ranging impact on issues of validity and legality of derivative transactions.

Wager analysis:

A related issue is whether a derivatives transaction can be said to a contract for wager and hence invalid as per the terms of the Indian Contract Act 1872 (**"ICA"**). However, the law in this area is not very clear. The outcome would be determined on the basis of the facts and circumstances of each case. A contract wherein the element of wagering was merely a subordinate element, and did not constitute the substance of the transaction would be valid and enforceable. However, a transaction may be regarded as a wagering contract if the object was pure speculation or where the primary object of the transaction was speculation. A crucial element in determining whether or not a contract amounts to wager is the intention of parties. Another factor which may also have a bearing is whether the settlement takes place by way of 'netting off' of the differential or by an exchange of the underlying currencies. The former may be held to be speculative in nature.

Exchange control issues:

The Rupee is not fully convertible on the capital account, though it is moving towards that direction. Hence, Indian resident cannot enter into a derivative contract directly with counterparts overseas. Such transactions have to be channeled through an authorized dealer. Besides this, there are some other exchange control regulations which govern cross-border transactions.

Termination of transactions:

The Foreign Exchange Dealers' Association of India (**FEDAI**) has recommended the adoption of the International Swap Dealers' Association's (**ISDA**) Agreement. Hence most of the issues of termination and the ancillary issues arising out of termination are governed by the standard terms and conditions of the ISDA Agreement. The events of default under the ISDA are quite stringent and these have given rise to some concerns. One such concern relates to the ability of the overseas party to terminate all transactions ("automatic termination") under an agreement relying on the default of the Indian party. The overseas party can terminate all transactions provided that the agreement has a clause providing for such a measure.

Insolvency issues:

The insolvency issues include the question of preference of payments upon insolvency proceedings being initiated. Another issue that may arise is whether a payment made or security delivered once bankruptcy proceedings have been initiated is valid. Such payments are generally valid unless they are fraudulent payments made to defeat valid claims under liquidation proceedings. Another concern related to insolvency risk is whether or not setting off of exposures would be permitted. A creditor claiming to prove a debt against an insolvent company in liquidation is entitled to set off its related claims. Even cross claims arising out of two separate contracts can be set off, if the two contracts are sufficiently connected and form part of the same transaction.

FINANCIAL DERIVATIVES

As the market grows, there is a demand for different instruments to help investors hedge, diversify and control different risks associated with them. The use of 'futures' and 'options' is an option available to the investor to hedge the market risks in probably the most cost-efficient manner. According to the L. C. Gupta Committee formed in November 1996, "the development of futures trading is an advancement over forward trading, and futures represent a more efficient way of hedging risk". The nature of a derivatives contract is to create liquidity, to allow risks to be distributed, to permit a party to take a position on the future value of an asset without actually acquiring it, and to obtain the benefit of its increased value and avoid loss if the value of the asset depreciates in that period of time.

A financial derivative is a financial instrument whose value is linked in some way to the value of another instrument, underlying the transaction. The value is derived from a basic financial instrument. The underlying assets could be securities, commodities, currencies or indices. Financial derivatives provide for the purchase or sale of traditional financial instruments in the future at prices that are agreed upon on the day of the contract. Financial derivatives are used for hedging, speculation and arbitrage.

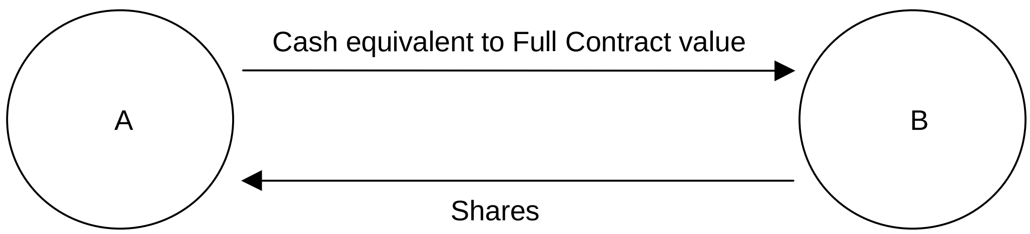
The OECD in its 1994 report entitled "Taxation of New Financial Instrument" provides for a comparative analysis of the tax treatment of four kinds of financial instruments: interest rate swaps, financial futures, option to buy shares and deep-discount bonds. After noting that many payments arising from financial instruments are similar in economic function to interest, the report admits that "it is unlikely that the definition of interest used in the Model Tax Convention is broad enough to encompass them all" and that "even payments on interest rate swaps, which may be a stream of payments calculated on an interest basis, are not income from debt claim. They are income from interest rate swaps."

We will now deal with some of these financial instruments and subsequently, with their tax implications.

Forward Contracts

They are the simplest form of derivative contracts. Traders and investors who wish to hedge against their future risks use the forward markets. This market is characterized by actual delivery of the underlying asset in most cases at the pre-determined date. Such contracts are used to hedge against price fluctuations.

Example 1: 'A' agrees to purchase from 'B' 100 shares of 'C Ltd.' on a fixed future date for a pre-determined price of Rs. 100. Here, on the fixed future date, A will pay Rs. 100 to B and B will deliver the shares of C Ltd. to A.



Futures

A future contract is a contract by which one party agrees to sell to the other party on a specified future date, a specified asset at a price agreed at the time of the contract and payable on the maturity date. The agreed price is also known as 'strike price'. The asset may be a commodity or currency or debt or equity security (or a basket of securities) or a deposit of money by way of loan or any other category of property. The effect is to guarantee or hedge the price. The hedging party protects himself against a loss, but also loses the chance to make a profit. Unlike forward contracts, futures are usually performed (settled) by the payment of difference between the strike price and the market price on the fixed future date, and not by physical delivery and payment in full on that date.

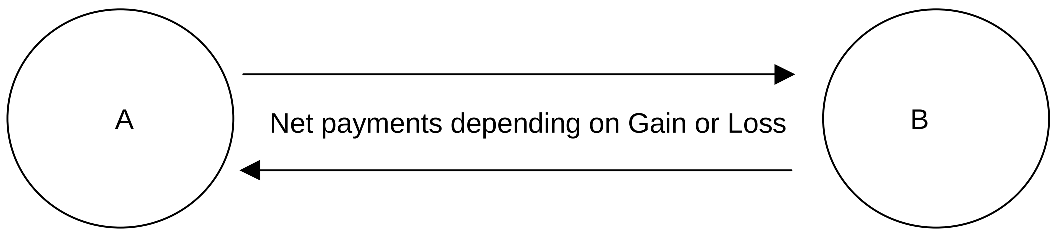
Financial futures originated in Chicago in 1972 by the introduction of currency futures by the International Monetary Market (IMM). This was followed by the introduction of Treasury Bond futures (interest rate futures) in 1977. Stock index futures soon followed in 1982. The basic difference between commodity and financial futures is that the asset represented by a financial future may not exist (for example, futures on a stock index represent only a hypothetical portfolio of the constituent stocks). Hence, such contracts cannot be settled by physical delivery of underlying shares and have to be settled by cash on the date of delivery. Also, financial futures are usually available with a longer life as compared to commodity futures. Usually, financial futures have standardized maturity dates.

Some types of financial futures contracts are:

- Currency futures
- Interest futures
- Stock index futures

The following example can explain a typical future transaction :

Example 2: 'A' enters into a future contract to purchase from 'B' shares of C Ltd. at Rs. 100 on 31st December. If for instance, on 31st December, the price of C Ltd. is Rs. 90, then A will pay to B Rs. 10 per share. If the price of C Ltd. is Rs. 120 then B will pay to A Rs. 20 per share.

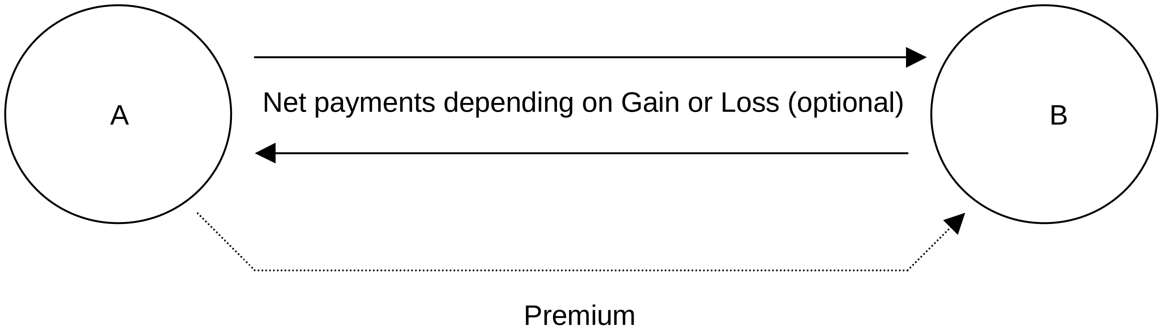


The basic difference between forward and future contracts is that in a forward contract, the entire principal flows from one party to another i.e. exchange of assets take place. In the case of future contracts, on the other hand, only the net differential between the strike price and the market price on the date of exercise is exchanged.

Options

An Option contract is a further variation of a forward or future contract. They are of two types, call options and put options. A call option is the right, but not an obligation, to buy an asset in the future at a pre-determined price. A put option is a right, but not an obligation, to sell an asset in the future at a pre-determined price. Similar to a future contract, the exercise of the option does not result into an actual obligation to sell or buy the asset against the full price, but results in a contract to pay the difference between the strike price and the market price on the date of exercise of the option. The buyer of the option will have to pay a premium for purchasing the option. The maximum loss that a buyer of the option may suffer is the amount of the premium paid. The seller of the option, on the other hand, has unlimited risk because the buyer can, by exercising his option, insist on performance.

Example 3: In example 2, if the price of C Ltd. on exercise date is Rs 120, than A will exercise the option as he stands to benefit from doing so. However, if the price falls to Rs. 90 then, he will not exercise the option, thus restricting his loss to the amount of the premium paid by him.



Caps, Floors and Collars

Caps, floors and collars are series of options. In a cap, the strike price for an option is not fixed, only an upper limit on the strike price is fixed. If on the maturity date, the market price is higher than the cap price then the cap price will be the strike price otherwise the market price will be the strike price.

A floor is similar to a cap, the only difference being that in case of floors the lower limit for the strike price is fixed.

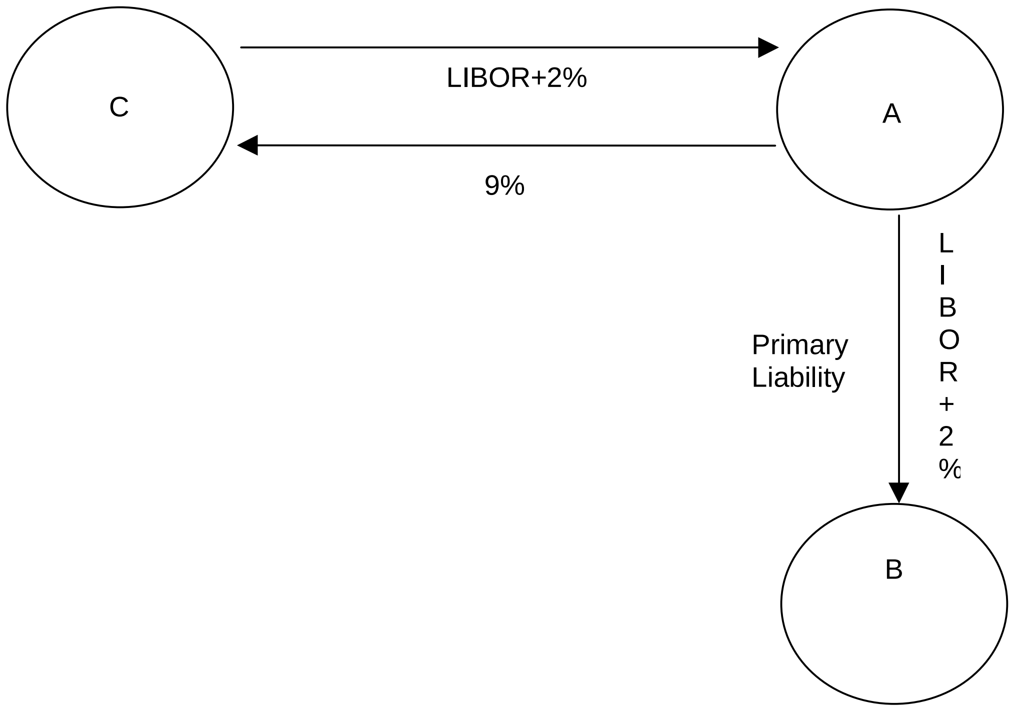
A collar is a combination of cap and floor. In this case, strike price will be within a range of prices. It can not be higher than cap price and lower than floor price determined in a collar contract.

Swaps

A swap is a contract whereby parties agree to exchange obligations that each of them have under their respective underlying contracts. In an interest rate swap, this would involve the exchange of a fixed rate of interest against a fluctuating rate of interest on the same notional principal. The rational for this could be that one party (usually a bank) is of a high credit standing and hence it can borrow at a fixed rate whereas the other party is not in a position to borrow at a cheaper or fixed rate of finance. Therefore, in a swap transaction, the party with a fluctuating interest liability will exchange this liability for a fixed interest liability. The interest rate differential will be exchanged between the parties on the settlement date.

A plain vanilla currency swap involves the following steps:
1. Exchange of equivalent amounts in different currencies
2. Exchange of interest payment during the tenure of the swap
3. Re-exchange of the principal sum at the pre-determined rate on the maturity of the swap agreement.

Example 4: A has borrowed from B at LIBOR + 2%. A now desires a fixed rate of interest at about 9%. C on the other hand is another player in the market, who is willing to borrow at LIBOR + 2% and lend at 9%. A and C can enter into a swap transaction whereby A borrows from C at 9% and lends to C at LIBOR + 2% on a notional principal. The actual amounts of the principals are never exchanged. Only the interest payments are exchanged on net basis.



The net result of the entire transaction is that liability of A is fixed at 9%. If LIBOR is 5% then A will have to pay C an amount of 2% of the notional principal. If LIBOR is 8% then C will pay A an amount of 1% of the notional principal.

TAXATION OF FINANCIAL DERIVATIVES

Taxation of derivatives is perhaps as complex an exercise as the transaction itself. A number of issues arise out of these transactions to which there are no well defined answers. The legal analysis of derivatives is fundamental to understanding its taxation. Several questions arise about characterization of income, treatment of the derivative and the underlying transaction etc. The issues get more intricate in the context of cross-border transactions. Characterization of income assumes greater importance as most of the tax treaties exempt 'business income' or 'other income' from taxation in the source country unless there is a Permanent Establishment. The lack of international consensus on taxation could lead to multiple taxation of a derivative transaction.

Internationally and especially in the UK there have been a number of reports on 'taxation of derivatives'. Some of them are :

1. "Tax aspects of derivative financial instruments" IFA, Cahiers vol. LXXXI, 1995
2. "Statement of Recommended Accounting Practice : Derivatives", British Bankers' Association, 1995
3. "Derivatives and Other Financial Instruments" Discussion paper on Accounting Standards Board, July 1996
4. "Taxation of Global Trading of Financial Instruments" Draft OECD Commentaries, 1997
5. "The Taxation of Derivatives" by David Southern, British Tax Review, 1998

IFA has published a comparative study of taxation of derivatives in about 29 countries. As per the study, there are three basic approaches to taxation of derivatives :

(1) Decomposition principle - under which every derivative transaction is analyzed into a number of cash flows, each of which can be separately valued and taxed
(2) Separate Transaction principle - under which each derivative contract is looked at in isolation to establish an overall return on investment
(3) Linked approach - under which the related transactions are clubbed together to analyze the overall profit of the entire transaction.

There seems to be a general acceptance of the theory that the taxation of derivative financial instruments (popularly known as DFIs) is not to be determined by reference to the tax treatment of the underlying instrument to which the derivative relates. Most countries seem to have adopted the second i.e. separate transaction principle.

There are three key issues in taxation of a derivative transaction :

1) Characterization of income i.e. business income or interest
2) Determination of income i.e. timing and cash flow
3) Withholding tax implications

Unlike traditional debt and equity securities and foreign currency, derivative financial instruments do not involve a return on initial investment. In view of this peculiarity, the characterization of income is of great significance in order to determine its taxability. Whether the income arising from a derivative transaction can be regarded as interest, has been dealt with in the 1994 Report of the OECD on "Taxation of New Financial Instruments". In 1995, Paragraph 21.1 was added to the OECD Commentary on Article 11 which made it abundantly clear that in the absence of underlying debt, the payment for a financial instrument will not be regarded as 'interest'. This was made subject to 'substance over form' rule and 'abuse of rights' principle. In general, the income arising from a derivative transaction should be regarded as 'ordinary income'. If a derivative transaction is entered into in the ordinary course of business, it should be considered as 'business income' otherwise, it should be characterized as 'other income'. In a cross-border transaction where a tax treaty applies, under both these situations, income arising from a derivative transaction should not be taxable in the country of source unless there exists a Permanent Establishment.

The next issue arises as to when the income should be taxed. There are several points at which the income from a derivative transaction may arise. Initially, there may be a premium paid. In many transactions, there will be intermediate value dates on which interest or dividend becomes payable on the underlying securities. Further, many contracts are 'marked to market" which means that their value is adjusted in view of the market value of the underlying asset on a periodic basis. Finally, at the maturity, there is an ultimate settlement of the difference. When and how to tax these cash flows may to some extend depend upon the method of accounting adopted by the tax payer.

Since in most of the cross-border transactions, derivative income may not be taxed in the absence of a PE, it is crucial that there are no withholding taxes leviable on such income. However, this will depend upon the domestic tax law provisions in each country and the provisions of relevant tax treaties applicable to such companies.

We will now examine how these issues are addressed under our local income tax law.

Taxation of Derivatives in India

Derivative transactions are still in nascent stage in India and their tax implications are still to be tested by the Indian revenue authorities. There are no precedents directly on the subject. Margins in a swap transaction are extremely narrow. Therefore, the imposition of taxes by the country of the payer substantially alters the profitability of a swap.

General provision under the Income tax Act:

Indian residents are subject to tax on their worldwide income, non-residents on the other hand are taxed only on income received by them in India, or income that accrues or arises to them in India[2]. Further, under certain conditions, income can be "deemed to accrue or arise in India" and thereby be subject to tax in India[3]. Generally, the entire tax payable by a non-resident in respect of income earned in India is liable to be withheld at source.

Taxation under the I-T Act

Section 9 of the *I-T Act* covers situations under which income which can be "deemed to accrue or arise in India". Under Section 9(1)(i) of the *I-T Act*, all income accruing or arising, through or from any business connection/property/asset or source of income in India, is deemed to accrue or arise in India[4]. Only such part of the income as is reasonably attributable to the operations carried out in India can be deemed to accrue or arise in India.[5]

[2] Section 5 of the Income Tax Act, 1961
[3] Section 9 of the Income Tax Act, 1961
[4] Section 9(1)(i) reads as follows:

"All income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, or through the transfer of a capital asset situated in India is deemed to accrue or arise in India"

[5] Explanation (a) to section 9 reads as under:

"For the purpose of this clause – in the case of a business of which all the operations are not carried out in India, the income of the business deemed under this clause to accrue or arise in India shall be only such part of the income as is reasonably attributed to the operations carried out in India."

Unlike in the United Kingdom, the Indian tax laws do not specifically distinguish between "doing business in India" and "doing business with India". The term "business connection" which is crucial to determination of taxable business income in India, is not statutorily defined. Therefore, this term is to be understood based on interpretation provided by courts. In general, it can be interpreted as a continuous relationship between a business carried on by a non-resident entity, which yields profits or gains and some activity (in India) which contributes directly or indirectly to the earning of these profits or gains.

Whether payments under derivative transactions would constitute "Income deemed to accrue or arise in India" is a question which can be dealt with only *qua* facts of a specific transaction. The *I-T Act* does not specifically deal with the tax incidence of income flows arising out of a derivative transaction. Indian courts have also not analyzed the taxation of such income. Though there are no direct cases on the point, courts have opined on the taxability of profits/losses arising to an assessee merely due to the appreciation or depreciation in the value of foreign currency held by it. The position adopted by courts has been that such profits/losses would ordinarily be trading profit/losses if the foreign currency is held by the assessee in revenue account or as a trading asset or as part of circulating capital. If, on the other hand, the foreign currency is held by the assessee as a capital asset or as fixed capital, such profit or loss would be of capital nature. (*Sutlej Cotten Mills V. CIT***,** (1979) 116 ITR 1, *State Bank of Travancore v. CIT*, (1986) 158 ITR 102).

Section 10(15)(iv) of the I-T Act exempts certain types interest payments from taxation in India. The Finance Act, 1999 has enlarged the scope of the word 'interest'. Now, interest includes hedging transaction charges on account of currency fluctuation. This would mean that any payment made for hedging against foreign currency rate fluctuations in respect of foreign currency debt obligation may be exempt from taxation in India.

<u>Tax Treaty Provisions:</u>

India has tax treaties with a number of countries. Indian tax law is unique as it statutorily offers a tax payer choice between the provisions of the treaty and the domestic tax law under Section 90 (2) of the *I-T Act*[6]. The effect of this section is that, a tax payer may opt for the treaty or I-T Act, whichever is more beneficial.

Most comprehensive treaties give the country of source the right to tax business income only if the recipient has a Permanent Establishment (**PE**) in the country of source. PE is a much narrower concept than "business connection". Therefore, many foreign parties, which may have a "business connection" in India by virtue of having the counter party in India and source of income in India, may not have a PE in India. This distinction is so crucial that the entire income, which could be taxable under the first concept, could be tax exempt under the

[6] Section 90 (2) of the *I-T Act* reads as follows:
"Where the Central Government has entered into an agreement with the Government of any country outside India under sub section (1) for granting relief of tax, or as the case may be, avoidance of double taxation , then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to the beneficiary."

other one. In the absence of a permanent establishment in India, the business income arising out of the derivative transactions made by the Indian payer, will not be subject to tax in India.

Even if a PE is found to exist, only such part of the business income, which is attributable to the permanent establishment, can be taxable in India. Such income is taxable on 'net' basis after deduction of certain expenses. While foreign companies are taxed at the rate of 48 %, domestic companies are taxed at the rate of 35% on such business profits. The Non-discrimination Article in some of the tax treaties may help reduce the tax incidence from 48% to 35%.[7]

For giving effect to the treaty provisions, reliance will have to be placed by the Indian counterparty on the payee representations. The payee may have to provide evidence that it qualifies for the relevant exemption from withholding taxes. The Indian counterparty can withhold the tax at the rates in force.[8]

Non-residents are eligible for applying for an advance ruling which is available on an existing or a proposed transaction, on questions of law or facts. These rulings are binding upon the applicant and the tax authorities, in respect of that applicant. Such a ruling may help the foreign counter party to determine the relevant tax implications in India.

<u>Withholding Tax :</u>

In a cross-border DFI transaction, withholding tax is a crucial question as the traders want their cash flows free of taxes. In general, withholding tax is levied on interest, dividend or royalty payments. Most countries have regarded payments under derivative contracts as falling outside 'interest' and 'dividend' articles as they do not reflect the true return on capital[9]. The same principle should apply to payments of differences on futures contracts, swap fees and premiums on options. Most of these payments fall within 'business profits' or 'other income' articles and therefore, are remitted gross, free of withholding taxes. The taxation is determined in the country of residence.

In India, the position is slightly different. *Section 195(1)* of the *I-T Act* entrusts the payer with the liability to withhold tax on certain payments being made to a foreign recipient[10]. An issue

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[7] There has been a recent advance ruling in the case of a French bank, which has been denied the benefits of non-discrimination article under India-French treaty for reduction of tax rate. (*Advance Ruling Application No. P – 16 of 1998, In re), (1999) 102 TAXMAN 377 (AAR – New Delhi)*

[8] " Rate or Rates in force " has been defined under Section 2(37A) to include:

"…… (iii) for the purposes of deduction of tax under section 195, the rate or rates of income tax specified in this behalf in the Finance Act of the relevant year or the rate or rates of tax specified in an agreement entered into by the Central Government under section 90, whichever is applicable by virtue of the provisions of section 90.……."

[9] 'The Taxation of Derivative', British Tax Review, 1998

[10] The section reads as follows:

"Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest (not being interest on securities) or any other sum chargeable under the provisions of the I-T Act, not being arises with respect to withholdings under section 195 that whether the payer has to deduct tax on the gross amount of payments due to the non-resident, or on the income or profit element received by the non-resident. The Supreme Court has authoritatively settled this issue in the case of *Transmission Corporation of AP Ltd. V. CIT*[11]. The Apex court has held that the scheme under section 195 of the ITA applies not only to the amounts that bear an element of income or profit, but also to gross sums, the whole of which may not be income or profit of the recipient.

In order to obtain an exemption from withholding any tax, or for withholding tax at a lower rate, the payer/payee will have to file an application with the Assessing Officer to determine the appropriate portion of the sum that should be chargeable to tax[12]. However, it should be noted that a certificate granted in this regard is only provisional. Final tax liability is ascertained upon regular assessment after a tax return is filed (if necessary)[13].

It is pertinent to note that in case of a banking company, exemption from withholding taxes is available only if the payments (not classified as interest on securities or dividend) are received by the branch operating in India, on its own account and are not received on behalf of the head office or any other branch situated outside India.

Thus, the Indian payer making payments to overseas parties under a derivative transaction is generally liable to withhold tax at source. The procedure for obtaining this lower tax withholding certificate has been recently simplified. Now, based on a Chartered Accountant's certificate, the Indian payer can remit the payment after withholding tax at the lower rate applicable under the treaty or without withholding any tax, as the case may be. However, it has to submit an undertaking that it shall undertake to pay the shortfall in tax, interest or penalty, which are payable in accordance with the provisions of *I-T Act*.

Gross-up of Tax :

Under the terms of the ISDA Master Agreement, the payer has to bear the burden of withholding taxes, where the tax is payable because of a connection with its chosen tax jurisdiction (*i.e.:* India). The burden to bear the taxes falls upon the payee only in limited circumstances where the payee has made a representation which is not true at the time it is made or which becomes untrue as a result of subsequent events or where the payee fails to conform to a provision in the ISDA Master Agreement requiring performance of a tax related obligation.

In India, however the payer will have to comply with the provisions of *section 195A* of the *I-T Act* read together with *circular number 370 issued by the Central Board of Direct Taxes*. These require that when the payer bears the income tax liability, the calculation of tax to be

income chargeable under the head `Salaries' shall at the time of credit of such income to the account of the payee or at the time of payment thereof in cash, or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income tax thereon at the rates in force."

[11] 239 ITR 587.

[12] Sections 195(2),(3), and 197 of the ITA.

[13] Section 197 of the *I-T Act*.

withheld at source should be made not with reference to the 'net-of-tax' amount payable to the non-resident payee, but should be made with reference to the gross amount. This provision may further affect the profitability of a derivative transaction in India.

Tax Implications on Swaps :

Taxation of swap payments is fairly complicated. The issue involved is one of characterization of the settlement amount. The characterization of the amount could be either business income or interest income. There is a strong case for the swap payment to constitute business income in the hands of the non-resident recipient as against interest income or other income.

Under the *I-T Act*, the term "interest" is defined under section 2(28A) to mean interest payable in any manner in respect of moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized.

In a swap transaction, there is no money borrowed or debt incurred. The principal of a swap deal is the notional amount and the adjustment takes place between the bank and the counterparty in respect of the amounts payable by them. Only the net amount changes hands. Therefore, such amounts should qualify as trading income. However, in a synthetic transaction, where the deal is structured in a manner where there is a debt incurred and the payment is made in respect of debt incurred, such payment could be regarded as 'interest'. In the Indian context, such a situation may be the practical reality faced by the Indian corporates who are forced to enter into synthetic transactions. The consequences may be different in a cross-border transaction, especially where the non-resident counterparty is from a treaty jurisdiction.

Article 11(3) of the OECD Model Convention defines interest as :

"The term interest as used in this Article means **income from debt-claim** of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds and debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article."

Thus, even the definition of OECD Model Convention (**OECD MC**) lays emphasis on the debt-claim. The commentary to OECD MC also supports the above argument[14].

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[14] Paragraph 21.1 on financial derivatives of the commentary to the OECD MC states that,

"The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of nontraditional 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."

Thus it can be concluded that, as long as the underlying 'debt-claim' remains purely hypothetical, the equalization payment is not interest. The fact that the swap was created, to secure the payments on a loan does not change the payment into interest. However, if one party pays a lumpsum amount to the other and the same is repaid over the course of the swap (an off-market swap), the return and equalization payments could be seen to contain a loan element.[15]

If these amounts were to be treated as interest, they may attract a withholding tax in India at the rate of 20% on the gross amount[16]. This rate could be reduced further depending upon the tax treaty provisions. If a foreign company earns any business income that is deemed to accrue or arise in India, it would be liable to be taxed at the current applicable rate of 48% on its net business income.

TAXATION OF DERIVATIVES IN SOME COUNTRIES

United States[17]:

Under US tax laws gains or losses are either classified as capital gains/losses or as a part of ordinary income. Capital gains are taxed at the same rate as ordinary income while the ability to deduct capital losses is restricted. For a non-corporate taxpayer, capital losses are deductible only to the extent of capital gains plus ordinary income upto $ 3,000. A non-corporate taxpayer can carry forward a net capital loss for an unlimited period of time. For a corporate tax payer, capital losses are deductible only to the extent of the capital gains. A corporation may carry back a capital loss upto three years. Any excess can be carried forward for five years.

Any gains or losses on contracts other than foreign currency contracts are treated as capital gains/losses. Gains or losses on foreign currency contracts are treated as ordinary income/losses. Hedging instruments are exempt from the foregoing rule. Gains or losses from hedging transactions are treated as ordinary income. A hedging transaction is defined under the tax regulations as a transaction entered into in the normal course of business primarily for one of the following reasons:

1. To reduce the risk of price changes or currency fluctuations with respect to property that is held or to be held by the taxpayer for the purposes of producing ordinary income.
2. To reduce the risk of price or interest rate changes or currency fluctuations with respect to borrowings made by the taxpayer.

Gains and losses from the trading of stock options are taxed as capital gains or losses. A gain or loss is recognized when:

[15] Page 738 of Klaus Vogel on Double Taxation Convention, third edition.
[16] Section 115 A of the *I-T Act*.
[17] "Futures Markets and the Use of Futures for Hedging" (publishing details unknown)

- The option is allowed to expire unexercised, or
- The option is sold, or
- The option is exercised.

If a call option is exercised, the writer is deemed to have sold the stock at the strike price plus the original call price. The party with a long position is deemed to have purchased the stock at the strike price plus the call price.

If a put option is exercised, the party with a long position is deemed to have sold stock for the strike price less the original put price. The writer is deemed to have bought stock for the strike price less the original put price. In all cases, brokerage commissions are deductible.

The Wash Sale Rule:

Under the wash sale rule, the tax authorities have ruled that when a security is repurchased within 30 days after the sale of such security, any loss on the sale is not deductible. This rule is relevant to option traders. Selling a stock at a loss and buying a call option within a 30 day period may lead to the loss being disallowed.

The Netherlands[18]

In the Netherlands, the parties involved in a swap transactions (whether OTC or publicly-traded contracts) are divided into two categories:

- Residents and
- Non-residents

A resident taxpayer who trades in derivative products is generally taxed on his trading profits. The concept of trading profits does not distinguish between income and capital gains. The determination of profits on long-term transactions (i.e. transactions spanning the balance sheet date) is a matter of tax accounting and recognized according to sound business principle and principles laid down by the courts. The most relevant principles are principles of prudence and principle of reality. Consequence of the first principle is that a loss can be accounted for when it arises, but accounting of profits can be postponed till they are realized. As a consequence of second principle, if a transaction is hedged, it is not acceptable to show a loss on one leg without accounting for an offsetting gain on the other leg. There is a clear conflict between two principles. Principle of prudence will allow to book loss without booking profits whereas principle of reality will require reporting of combined results.

As regards non-residents, trading with a counterparty based in the Netherlands should not cause a non-resident to be subject to any Netherlands tax unless it is shown that the non-resident has a permanent establishment in the Netherlands.

[18] "Derivatives 1999" - International Financial Law Review

France

The French tax treatment of financial derivatives is governed by Article 38 of the French Code General des Impots (**Code**). The products are distinguished between over-the-counter transactions and transactions on organized markets.

Over-the-counter products:

The following instruments are considered as over-the-counter financial products:

- Interest rate swaps;
- Forward Rate Agreement;
- Option-derived products (caps, floors, collars); and
- Forward sale and purchase contracts.

Organized market products:

The following products are considered as dealt in the organized market:

- Contracts and options traded on the MATIF and MONEP; and
- Foreign currency transactions (including currency swaps).

Tax treatment

Over-the-counter products:

Articles 38.1 and 38.2 of the Code provide that unrealized profits are taxable only at the outcome of the contract. The losses incurred may be deducted through a deductible reserve only to the extent that a global estimated budget of the operation involved has been prepared and reflects a global loss.

Organized market products:

Article 38.6.1 of the Code sets forth as a general principle the application of the mark-to-market rule to operations involving financial futures on organized markets. Article 38.6.2 provides a special tax treatment for operations, the sole purpose of which is the hedging of a transaction due to occur during the following financial year. In this case, the profit realized through the hedging instrument is not taxable at the end of financial year but at the outcome of the contract. To qualify for the tax treatment of hedging transactions, an economic hedge must meet the following conditions:

- The sole purpose of the use of a forward instrument must be hedging of a transaction due to happen in the following year and traded in another type of market;
- The occurrence in the next year of the transaction must be highly likely; and
- The correlation between the value of the hedging instrument and of the hedged element must be sufficient (however, a sufficient correlation is not defined).

In addition, a document indication the main characteristics of the hedged element and of the hedging instrument must be transmitted to the tax authorities.

Matching transactions

Transactions will be considered as matching transactions for the purpose of Article 38.6.3 if the evolutions in value of the two positions are opposed and correlated. As a consequence of this qualification, the loss incurred on the first transaction is only deductible up to the part that exceeds the untaxed profits on the other transactions.

When a company or a financial institution realizes matching transactions, it must transmit to the tax authorities a document mentioning all these transactions. If this return is not made, the losses are non-deductible.

United Kingdom[19]

UK has a comprehensive new code for the taxation of derivative financial instruments. Other jurisdictions have preferred to absorb derivatives within existing taxation categories. The legislation is constructed on a "separate transaction principal". This is in conformity with the view taken by courts. Courts in UK have refused to treat various derivative contracts entered into by the same entity as one overall transaction, and have established the separate transaction principle as the correct basis for legal analysis. Consequently, though netting off of payments under a single contract is allowed, payments between the same parties under different contracts cannot be netted off for tax purposes.

The qualifying contracts to which the legislation applies, are interest rate contracts, interest rate options, currency contracts, currency options, debt contracts and debt options[20]. Qualifying contracts are defined by reference to qualifying payments, which have been defined with considerable elaboration. This permits flexibility in taxing derivative transactions, even if they do not fall under the above mentioned categories of qualifying contracts. All profits and losses on financial instruments are treated as revenue items.

Brazil[21]:

In Brazil, the net results of transactions carried out to cover risks on stock exchanges and other futures markets abroad are computed on the basis of book taxable income derived by the entity. Book taxable income is the real profit, which is the net income for the tax period determined according to commercial laws, plus the additions and deductions authorized by the income tax laws.

There is no withholding tax on payments made to non-residents pursuant to hedging transactions.

[19] David Southern, The taxation of Derivatives, (1998) BTR No. 4
[20] Finance Act, 1994, sections 149, 150, 150A.
[21] Fernando Ruiz de Almeida Prado, "Taxation of Derivatives and Financial Instruments" Derivatives and Financial Instruments, IBFD, Vol 1, 1999, p. 6.

Pakistan[22]

The most crucial issue in respect of financial instruments involving futures contracts is the classification of goods as capital assets or stock in trade. Depending on the classification, the income from such contracts will be charged as either capital gains or business profits. Deductibility of expenses under the two headings, i.e. capital gains and business profits are different. In Pakistan, stock and shares are treated as capital assets even if they are held as stock-in-trade by a taxpayer.

The taxation of futures contracts, if these constitute business, will be taxed under the distinct head of "speculative business". Speculative business has been defined to include businesses in which a contract for the purchase and sale of any commodity, including shares is periodically or ultimately settled other than by actual delivery or transfer of that commodity. Certain hedging transactions entered into by manufacturers and dealers etc., to guard against losses from price fluctuations in the ordinary course of business have been specifically excluded[23]. Loss in a speculative business can be set off only against the profits of another speculative business. Also, such losses can be carried forward for a maximum period of six years[24].

TAXATION OF CURRENCY SWAPS IN SOME COUNTRIES[25]

Belgium

In Belgium, the tax laws do not provide specific rules governing currency swaps. The tax treatment must be understood within the framework of the general accounting and income tax principles. Under these principles, the currency swap payments are considered tax deductible as they are paid in order to receive payment in another currency, which is taxable. Unrealized losses or gains could also be tax deductible or taxable as the case may be. Currency swap payments are normally not subject to withholding tax in Belgium, regardless of whether they are paid to residents or non-residents. In a cross-border transaction, currency swap payments received by a non-resident are not taxable in Belgium unless they are attributable to the PE of the non-resident in Belgium. However, when the currency swap transactions are used to convert interest income into capital gains, they could be regarded as interest and subject to a withholding tax of 15%.

Canada

In Canada, swap is regarded as distinct from any related loan transaction. Interim payments are not regarded as interest. But if they are incurred for earning income, such payments are considered tax deductible; otherwise they are considered to be on capital account. Upon

[22] Ikrumal haq, "Taxation of Futures Contracts", Derivatives and Financial Instruments, IBFD, Vol 1, 1999, p. 6.
[23] Section 36(2) of the Income tax Ordinance, 1979.
[24] Sections 34 and 36 of the Income tax Ordinance, 1979.
[25] "Derivatives & Financial Instruments" - IBFD, Vol. 1 No.1, 1999

completion, foreign exchange loss or gain is associated with the underlying transaction. It is treated as capital or revenue, depending upon the associated transaction. Though, in general, withholding tax is not applied; where reciprocal payments are not made at the same intervals, some element of interest could be deemed and subject to a withholding tax in Canada.

<u>Switzerland</u>

The tax treatment of swap agreements is not subject to special regulations. Instead, the general rules apply. The key features in this regard are:

1. Payments received under swap agreement, although having characteristics of interest payments are not considered as interest but rather as payments under contractual obligation.
2. The mid-term payments constitute taxable income or tax-deductible expense.
3. The payments are generally not subject to any withholding tax
4. Gains and losses over the lifetime of the swap constitute taxable income or are expensed in the respective tax period.

TAX PLANNING

It may be possible to plan the swap transactions and the entities entering into such transactions in a manner by which the tax implications in the source country can be substantially reduced. We will examine some of the planning avenues in the context of India. Since this a new area for the Indian revenue authorities, it may be advisable to ascertain the tax implications by obtaining an advance ruling on the proposed transactions. Some of the factors which may assist in tax planning are discussed below :

<u>Characerization of income :</u>

It is important that the income arising from the swap transactions qualifies as 'business income' and is not characterized as interest or otherwise. This is because payment of interest would, in most cases attract a withholding tax of 20 %. Under some exceptional treaties, this rate is reduced to 10% (Cyprus/Netherlands treaty) or 12.5% (U.A.E. treaty). Against this, business income will not be taxable unless the recipient has a PE in India. This can be achieved by contesting that the recipient has entered into such transaction in its ordinary course of business.

<u>Selection of entity :</u>

In general, a company is a better bet than an LLC particularly, where the members are from non-treaty countries. It is uncertain whether the treaty benefits will be available to an LLC *per se.* A company would generally qualify for treaty benefits. In addition, to be eligible for an advance ruling, it may also be required to establish proper tax residency in the treaty country by paying certain minimum tax in that country.

<u>Location of Counterparty :</u>

It would be advisable to select a counter party from a treaty jurisdiction. In the absence of a treaty, the domestic law and the concept of 'business connection' may prevail. The concept of 'business connection' being much wider it is likely that the nexus can be established and the non resident's income can be deemed to accrue or arise in India.

If the interested foreign party is located in a non-treaty jurisdiction, then it can select one of its subsidiary or affiliate based in a treaty jurisdiction to enter into the swap transaction with the Indian counter party. This would be subject to the anti abuse provisions in the tax treaty. If a branch is set up in a treaty jurisdiction, it is likely that this branch may not qualify for treaty benefits as it will not be regarded as a separate legal entity but a mere extension of the parent company (which is a resident of a non-treaty country). However, this position may differ from country to country.

CONCLUSION

In many countries, a definite position on the taxation of financial derivatives has not been reached as yet. There is also an ongoing discussion on which distributive rules of the current OECD Model Convention will apply to the income resulting from financial derivatives. The differences in national tax systems further complicate the difficulties already present in the double taxation treaties. Further clarity is required to be provided in the commentaries to model treaties to affirm the tax treatment of new instruments like financial derivatives.