

Taxation of hybrid instruments

Tax treatment of debt instruments without fixed right to redemption (Part 2)

In the past fifteen years, the financial markets have experienced a fast growing number of new hybrid instruments being issued by banks and other financial intermediaries. The common feature of all these financial instruments consists in the combination of a bond component together with an option component. The first part of the article has described the principles of taxation of portfolio income in Switzerland, both for the investor and for the issuer. The second part of the article describes the principles of taxation of hybrid instruments in Switzerland, both for the issuer and the investor, with a particular emphasis on debt instruments without fixed right to redemption.*

1. Introduction

In Switzerland, the taxation of hybrid instruments can follow either a *substance over form* approach (bifurcation approach), or a *form over substance* approach (integration approach), depending on the characteristics of the instrument.

2. Principles of taxation of hybrid instruments

2.1 Bifurcation or integration approach?

2.1.1 Types of products: transparent and non transparent

The tax treatment of financial instruments was recently revised through the federal tax administration which issued a new Circular on April 12, 1999 [1] (hereafter «the Circular»), which covers in particular hybrid instruments.

In Swiss tax law, hybrid instruments are divided into the following two categories [2]:

- (i) «Transparent» hybrid instruments: instruments subject to a bifurcation approach;



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- (ii) «Non transparent» hybrid instruments: instruments subject to an integration approach.

2.1.2 Qualifying criteria for the application of the bifurcation or integration approach: transparency

The bifurcation approach is applicable in all situations in which the (two) components of the hybrid instrument can be clearly (i) identified separately and (ii) valued separately, both (a) on the issuance day and (b) subsequently [3].

The possibility to formally and physically split the security into its various components [4] is not a condition for the bifurcation approach anymore. From now on, the only condition for the bifurcation approach is that the hybrid instrument must be «transparent» analytically [5].

A hybrid instrument is deemed to be analytically «transparent» when the issuer, upon the issuance of the hybrid instrument, (i) identifies in the prospectus all the components of the hybrid instrument, and (ii) publishes in such prospectus the value of each component of such hybrid instrument.

In addition, upon each transfer of the hybrid instrument after the issuance, the intermediary (generally a bank) must indicate the value [6] of each component of the hybrid instrument in the trade slip [7].

As long as the hybrid instrument can be analyzed transparently, a bifurcation approach is adopted by the tax authorities. Once this transparency is lost [8], an integration approach is to be applied by the tax authorities.

2.1.3 Valuation criteria used in the bifurcation approach

Generally, the two components of a hybrid instrument are (i) a bond com-

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ponent and (ii) an option strategy component.

In case of a bifurcation approach, the tax authorities and the taxpayer need to identify the fair market value of both components of the hybrid instrument, not only at the time of issuance, but also upon each transfer, since each component will be taxed according to its own characterization.

In case of a physical split of all the components of the hybrid instrument, market prices are to be given for the three types of securities, i.e. (i) the security for the combined hybrid instrument (bond cum option), (ii) the security for the bond component only (bond ex option) and (iii) the security for the option component (warrant). Hence, no valuation is to be done, the fair market value of each component of the instrument being given by the market itself [9].

In case the hybrid instrument cannot be split physically, the fair market value of the components of the hybrid instrument cannot be given directly by the financial markets. Hence, a financial valuation will be necessary for each component of the hybrid instrument. Since the fair market value of the combined hybrid instrument will be given by the financial markets, this financial valuation of each component of the combined instrument can be made, by simply deducting from the market price of the combined instrument, either (i) the financial value of the bond component, or (ii) the financial value of the option strategy component.

The first approach is easier and is the one adopted by the Swiss tax authorities. However, it is slightly different at the time of issuance [10] and at the time of transfer of the hybrid instrument [11].

2.1.4 Burden of proof

If an issuer is willing to avoid an integration approach for a new financial instrument, preferring that a bifurcation approach be instead adopted, he has the burden of proof and must prove that his hybrid instrument can be analyzed transparently like two different instruments that are combined together.

In case the issuer succeeds in this proof, an indication will be made in the official securities listing published yearly by the Swiss tax administration [12], mentioning the bifurcation approach applicable to the tax treatment of such hybrid financial instrument.

2.2 Tax consequences of the bifurcation or integration approach

2.2.1 Consequences of proof of existence of a hybrid instrument and of the valuation of the components

If the issuer succeeds in the proof, a bifurcation approach is to take place, and the tax treatment of each component of the hybrid instrument is to follow its own characterization.

- Generally speaking, it means that
- (i) part of the hybrid instrument is to be analyzed like a bond (ordinary or OID), on which income can take the form of either (a) interest or (b) capital gain, and
 - (ii) part of the instrument is to be analyzed like an option, which can trigger only capital gains, or losses.

2.2.2 Consequences of failure of proof of existence of a hybrid instrument or of valuation of the components

If the issuer does not succeed in its proof, an integration approach is to take place.

Generally speaking, the integration approach means that the *entire hybrid instrument* is to be analyzed like a bond, on which interest income can take the form of either (a) a fixed periodical interest component, corresponding to the real coupon, or (b) a variable interest at maturity, corresponding to the capital gain or loss on the option strategy component [13] or (c) a capital gain on the sale of the instrument before maturity.

3. Taxation of debt instruments without fixed right to redemption [14]

3.1 Cash flow pattern

Hybrid instruments without a fixed right to redemption generally corre-

spond to (i) a fixed income investment similar to a bond, together with (ii) a positive cash flow option strategy [15] [16].

The fixed income investment is represented either by (i) an ordinary bond (most frequent) or (ii) an original issue discount bond (OID) (frequent only with short term [17] hybrids without a fixed right to redemption).

The positive cash flow option strategy consists, for the investor, either (i) in a put sale [18], or (ii) in a combined put sale with a call purchase with a higher strike price (close to a synthetic long underlying) [19], or (iii) in a combined call sale with a put purchase with a higher strike price (close to a synthetic short underlying) [20].

The fixed payments guaranteed by the debtor to the investor are only the coupons payments corresponding to (i) the fixed interest due by the debtor to the bondholder and (ii) the (net) option premium(s) due by the option buyer to the option seller.

The final redemption payment is not fixed, but corresponds to the par value of the bond after deduction of the result of the option strategy at maturity.

3.2 Tax treatment of the periodical payments

3.2.1 Applicable to the resident receiver, on the gross income received

- *The holder is an individual not active in trade and business: privately held asset*

Both the coupons and the option premium are deemed earned and therefore included in the taxable income of the receiver, if taxable, at the value date of the coupons.

a) Transparent hybrid instruments

In application of the bifurcation approach, the periodical payments received by the investor and corresponding to the bond coupons component are qualified as interest income taxable at ordinary rates.

In application of the bifurcation approach, the periodical payments receiv-

ed by the investor and corresponding to the premium of the sold option(s) are to be characterized as tax-exempt capital gains arising from an option sale, for individuals, in case of privately held assets [21].

b) Non transparent hybrid instruments

In application of the integration approach, all periodical payments received by the investor, whether they correspond to (i) the bond coupons or to (ii) the premium of the sold option(s), are to be characterized entirely as interest income entirely taxable at ordinary rates.

– *The holder is an individual active in trade and business or a corporation: business assets*

Both the coupons and the option premium are deemed earned and therefore included in the taxable income of the receiver at the date of the book entry. This date corresponds, in principle, to the value date of the coupons.

However, the accrual method applies in case of business assets on the periodical payments, which implies that coupons not yet received but which have accrued are to be booked (and taxed) as earned income.

The entire income is to be taxed at ordinary rates, regardless of its source (interest income component or option premium component).

3.2.2 Tax base of the resident receiver

– *Individuals not active in trade and business: privately held assets*

For individuals not active in trade and business, the financing costs are deductible within the limitations described hereabove, together with the management fees or administrative fees paid to the bank or the portfolio manager, but excluding brokerage fees [22].

No other expense directly or indirectly linked to the hybrid instrument are deductible.

In particular, unrealized capital gains or losses are to be ignored. Realized losses have no impact on the taxation of the periodic payments.

– *The holder is an individual active in trade and business or a corporation: business assets*

Individuals active in trade and business are entitled to deduct, from the coupons and option premiums received, all commercially-justified expenses.

The booking of both realized and unrealized losses on a hybrid instrument as well as the entire financing costs and management or administrative fees paid to the banker, including brokerage fees, are considered as commercially-justified expenses.

Besides, a provision for the risk of loss linked to the change of value of the underlying of the option component must be booked [23] and is deductible from the taxable net income. The amount of the provision admitted as a deduction for tax purposes consist of the amount of the cost which would be incurred in case of a dynamic hedging strategy to neutralize the «short» option position embedded in the hybrid instrument.

For corporations, unrealized capital gains can be booked only if the hybrid instrument is included in the category «tradable securities» under current assets, and if the security is traded in a stock exchange. In this case, the company may value this asset at the average closing price during the month preceding the date of the balance sheet. The unrealized capital gain is then to be taxed at the time it is booked [24].

If either the hybrid instrument is not traded on a stock exchange and is included in the category «tradable securities», under current assets, or if a corporation books the hybrid instrument in the category «investments», under fixed assets of its balance sheet, unrealized capital gains cannot be booked, because in both cases, the asset then follows a cost approach, after deduction of the necessary adjustments both for accounting and tax purposes [25]. Hence, in such a case, unrealized capital gains are not taxed until either (a) a transfer or (b) the redemption of the hybrid instrument.

Banks are subject to the same general rules, with various exceptions included in the banking law and regulations. The

banking regulation on bookkeeping provides that hybrid instruments having an accrued interest component and held for the trading activity of the bank must be included in the category «tradable securities», under current assets [26]. If such a hybrid instrument is traded on a recognized stock exchange, the bank may then value this asset at the average closing price during the month preceding the date of the balance sheet, and hence book an unrealized capital gain, subject to tax. If it is not traded on such a recognized stock exchange, the bank has to book the hybrid instrument at cost, with the deduction of the necessary adjustments, which means that unrealized capital gains cannot be booked and hence are not taxable.

The banking regulation provides that if the hybrid instrument having an accrued interest component is not held as tradable securities or as a permanent investment, it must to be booked in the category «financial assets» under fixed assets [27]. This hybrid instrument must then follow a cost approach, with the deduction of the necessary adjustments, and unrealized capital gains cannot be booked and hence are not taxable. It is only in the case of convertible bonds or option bonds, and if the hybrid instrument is held as a permanent investment, that the banks are authorized to use a bifurcation approach for the accounting treatment of such hybrid instrument: on the entire bond component of the hybrid instrument, the bank will then be able to use the accrual method (and not only on the periodic coupon), while on the option component, it will have to adopt a cost method, with the deduction of the necessary adjustments. In such a case, the accrued interest will be taxable as it accrues, and not only at redemption or upon the sale of the instrument [28].

3.2.3 Applicable to the issuer

– *Withholding tax: income tax for non residents*

a) Transparent hybrid instruments

The bifurcation approach may also be applicable for the Swiss withholding tax if the product is transparent [29].

Hence, in case of bifurcation, if the debtor is a Swiss resident, the 35 % Swiss withholding tax is to be levied only on the interest coupon component, at the coupon value date [30]. No withholding tax is to be levied on the option component of the periodical payments since it is not characterized as interest subject to the withholding tax [31].

b) Non transparent hybrid instruments

In this case, in application of the integration approach, the total periodical payments corresponding to both (i) the interest coupon component and (ii) the option(s) premium payment are to be characterized as interest subject to the 35 % withholding tax [32].

c) Common features

The Swiss withholding tax is due in case of a Swiss issuer, irrespectively from the country of residence of the holder of the hybrid instrument.

For Swiss residents, this withholding tax is entirely refunded, while for non-residents this tax may be refunded only (i) where a double tax treaty between Switzerland and the country of residence of the investor applies, and (ii) for the amount of the refund granted by the treaty.

Hence, if the bondholder is not a resident of a country entered into a double tax treaty with Switzerland, the withholding tax is to be considered as the equivalent of a special income tax on non-residents.

If the bond issuer is a foreign branch of the Swiss company or a foreign affiliate of the Swiss company, no withholding tax is levied in Switzerland on the coupon payments [33].

– Tax deductible expenses for the issuer

Generally, the issuer is either a corporation or an individual active in a trade or business.

These taxpayers are entitled to deduct from their net taxable income not only the coupons paid to the hybrid instrument holder, but also the periodical coupons accrued.

In addition, for the option strategy component, the issuer is allowed to constitute a provision if the residual value of the option component of the hybrid instrument is lower than the part of the future coupons payments corresponding to the option component. The expense linked with the constitution of such a provision is to be qualified as a commercially-justified expense entirely tax deductible.

This provision is to be assessed to ensure the coverage of a loss on the option strategy component, due to either a change in the market value of the underlying security or to the fall of the time value of the option.

As mentioned above, the thin capitalization rules do not apply to periodic payments if the bondholder is not a related party [34].

3.3 Tax consequences at redemption

3.3.1 Applicable to the resident receiver, on the gross income received

– The holder is an individual not active in trade and business: privately held assets

a) Transparent hybrid instruments

In application of the bifurcation approach, part of the redemption price of the bond component of the hybrid instrument may be qualified as interest income. The precise amount of the redemption price that can be qualified as such depends on the qualification of the bond component (original issue discount bond [OID] or not).

In case the bond component is not characterized as an original issue discount bond, only the difference on the bond component between (i) the (lower) issue price of the bond component and (ii) the (higher) redemption price of the bond component [35] can be characterized as taxable interest, since this difference is paid by the debtor to the bondholder [36]. If the bond is issued in a foreign currency, this difference is to be converted into Swiss francs at the foreign exchange rate applicable on the redemption date. Hence, a foreign exchange gain or a foreign exchange

loss trigger an effect only on the value of the issue discount or reimbursement premium qualified as interest; the currency gain or loss on the total invested capital remains tax exempt.

In the event the bond component is characterized as an original issue discount bond, the taxable interest corresponds to the difference between (i) the purchase price of the bond component and (ii) the redemption price of the bond component [37]. If the bond is issued in a foreign currency, the purchase price is to be converted into Swiss francs at the applicable foreign exchange rate of the purchase date, and the redemption price is to be converted into Swiss francs at the applicable foreign exchange rate of the redemption date. Hence, any foreign exchange currency gain on the entire instrument is also indirectly characterized as taxable interest income [38] (and any foreign exchange currency loss is indirectly deductible).

In application of the bifurcation approach, the difference on the option component between (i) the issue price of the option component [39] and (ii) the redemption price of the option component is to be qualified as a tax exempt capital gain or loss.

Furthermore, in case of a transparent short term reverse convertible bond with a maturity lower than a year, and to the extent that no sum is guaranteed by the issuer, the entire transaction is to be characterized as an option investment, with no bond component. The entire return is thus to be qualified as a tax exempt capital gain arising from a pure option transaction [40].

b) Non transparent hybrid instruments

In application of the integration approach, part of the redemption price of the entire hybrid instrument may be qualified as interest income. The precise amount of the redemption price that can be qualified as such depends on the qualification of the entire hybrid instrument (original issue discount bond [OID] or not).

In case the integrated hybrid instrument cannot be characterized as an ori-

ginal issue discount bond, the entire difference between (i) the total (lower) issue price of the hybrid instrument and (ii) the total (higher) redemption price of the hybrid instrument is to be qualified entirely as taxable interest, regardless of the source of the gain (option component or bond component) [41]. The entire difference is to be characterized as interest since (a) this difference is paid by the debtor to the bondholder, (b) it exceeds the mere redemption of the capital lent and (c) no distinction is made between the bond component and the option component of the hybrid instrument, in case of a non transparent instrument (integration approach) [42].

In case the integrated hybrid instrument is characterized as an original issue discount bond, the taxable interest corresponds to the difference between (i) the total purchase price of the hybrid instrument and (ii) the total redemption price of the hybrid instrument [43].

– *The holder is an individual active in trade and business or a corporation: business assets*

In this situation, the taxable amount corresponds to the difference between (i) the book value of the hybrid instrument, after taking into account past depreciations or provisions, and (ii) the total redemption proceeds.

The fact that the hybrid instrument is transparent or not, i.e. that a bifurcation or an integration approach is chosen, has no impact on the tax consequences, both components of the hybrid instrument (bond and option) being taxed similarly in case of business assets.

3.3.2 Tax base of the resident receiver

The principles described with respect to the periodic payments apply, with the following exceptions.

– *Individuals not active in trade and business: privately held assets*

In case of a bifurcation approach, capital losses are not deductible, since capital gains on the option component are tax exempt.

In case of an integration approach, a capital loss on the option component of a hybrid instrument is deductible (indirectly) only from the taxable issue discount or reimbursement premium, if any, on the bond component of the same hybrid instrument.

If the bond component, in case of a bifurcation approach, or the entire bond, in case of an integration approach, is not characterized as an original issue discount bond, capital losses on the bond are not deductible. If the bond is issued in a foreign currency, foreign exchange losses are not deductible.

If the bond component, in case of a bifurcation approach, or the entire bond, in case of an integration approach, is characterized as an original issue discount bond, the taxable interest corresponds to the difference between (i) the purchase price of the bond component and (ii) the redemption price of the bond component [44]. If this difference corresponds to a capital loss (purchase price higher than the redemption price), it can be deducted (i) from (and only from) capital gains realized on other OID bonds (component or instrument) and (ii) only from OID gains realized in the same tax period [45]. All the banking expenses, including brokerage fees, directly linked with the purchase and sale of the bond (component or instrument), are deductible in this case [46]. As mentioned above, if the bond is issued in a foreign currency, the purchase price is to be converted into Swiss francs at the applicable foreign exchange rate of the purchase date, and the redemption price is to be converted into Swiss francs at the applicable foreign exchange rate of the redemption date. Hence, any foreign exchange loss on such a bond is indirectly tax deductible from the income of the bond itself [47].

– *The holder is an individual active in trade and business or a corporation: business assets*

As mentioned above, the taxable income corresponds to the net difference between the redemption proceeds and the book value, the latter being computed after taking into account the past depreciation and provisions.

3.3.3 Applicable to the issuer

– *Withholding tax: income tax for non residents*

a) *Transparent hybrid instruments*

As mentioned above, the bifurcation approach also applies for withholding tax purposes.

Hence, if the debtor is a Swiss resident, the 35% Swiss withholding tax is to be levied at the maturity date on the issue discount or the reimbursement premium of the bond component, i.e. on the entire difference between (i) the total issue price of the bond component and (ii) the total redemption price of the bond component.

No withholding tax is to be levied on the net result of the option component paid by the issuer to the investor.

b) *Non transparent hybrid instruments*

In application of the integration approach, if the debtor is a Swiss resident, the 35% Swiss withholding tax is to be levied at the maturity date on the entire difference between (i) the total issue price of the hybrid instrument and (ii) the total redemption price of the hybrid instrument, including the net result on the option strategy, this entire difference being qualified as issue discount or reimbursement premium subject to the 35% withholding tax [48].

– *Tax deductible expenses for the issuer*

In addition to the deduction of the coupons paid or accrued to the hybrid instrument holder, the issuer is allowed to deduct the entire loss on the option component.

In case of a gain on the option component, this gain is entirely taxable.

The net taxable gain or loss is computed after taking into account previously constituted provisions.

The thin capitalization rules are generally not applicable if the holder is not a related party or, if it is otherwise, if the transaction takes place at arm's length prices.

3.4 Tax consequences in case of alienation of the instrument before expiry

3.4.1 Applicable to the resident seller

– *The seller is an individual not active in trade and business: privately held assets*

a) Transparent hybrid instruments

In application of the bifurcation approach, the difference, on the option component, between (i) the purchase price of the option component and (ii) the sale price of the option component is to be qualified as a tax exempt capital gain or loss [49], [50].

In application of the bifurcation approach, if the bond component does not qualify as an original issue discount bond, the difference between (i) the purchase price of the bond component and (ii) the sale price of the bond component is to be qualified as a tax exempt capital gain or loss [51], [52]. If the bond component qualifies as an OID bond, the capital gain corresponding to this difference is taxable and the capital loss is, in principle, not deductible [53].

The method used for the splitting of the capital gain between the option component and the bond component consists simply in subtracting from the sale price of the entire hybrid instrument the value of the bond component at the time of the sale. The value of the bond component at the time of the sale is computed by discounting the future cash flows of the bond component [54] for the remaining period up to maturity. The rate used for this discounting is the original yield to maturity of the bond component at the time of the bond issue, plus or less the change in interest rates on five years swap contracts between the issue date and the sale date of the hybrid instrument [55]. This method can artificially reduce the gain on the option component and exaggerate the gain on the bond component (or vice versa). This would be the case, for example, if interest rates on five years swap contracts fall more, since the issue date, than the current interest rate applicable (i) to the debtor of the bond at the time of valuation and (ii) for the remaining period up to maturity.

In case the hybrid bond is issued in a foreign currency, the valuation of the bond component is to be made using interest rates on five years swap contracts in the foreign currency. As mentioned above, foreign exchange gains on the bond component are indirectly taxable in case the bond component is qualified as an OID bond, and hence foreign exchange losses are indirectly deductible. If the bond component does not qualify as an OID bond, foreign exchange gains on the bond component are tax exempt and foreign exchange losses are not tax deductible [56].

b) Non transparent hybrid instruments

In application of the integration approach, in principle, the entire difference between (i) the purchase price of the hybrid instrument and (ii) the sale price of the hybrid instrument are characterized as a tax exempt capital gain or loss [57], unless the entire hybrid instrument can be characterized as an original issue discount bond [58].

If the entire integrated hybrid instrument is characterized as an original issue discount bond, the entire capital gain is taxable, including the option component (the option component could either include also a capital gain which would be indirectly taxable, or a capital loss, which would be indirectly deductible). Besides, in case of an OID characterization, a foreign exchange currency gain would indirectly be taxable, while a currency loss would indirectly be deductible [59].

– *The seller is an individual active in trade and business or a corporation: business assets*

In this case, the taxable amount corresponds to the difference between (i) the book value of the hybrid instrument, after taking into account both the past depreciations or provisions, and (ii) the total sale proceeds.

In this case also, the fact that the hybrid instrument is transparent or not, i.e. that a bifurcation or an integration approach is chosen, has no impact on the tax consequences, both components of the hybrid instrument (bond and op-

tion) being taxed similarly, as business profits.

3.4.2 Tax base of the resident seller

The principles described with respect to periodic payments and redemption apply. As far as currency gains and losses are concerned, see here above.

3.4.3 Applicable to the issuer

The principles set forth as for the periodic payments and redemption apply, except for the following particularities.

– *Withholding tax: income tax for non residents*

The alienation of the instrument before expiry is tax neutral from a withholding tax point of view. Actually, the debtor of the withholding tax is the debtor of the bond, and the debtor is generally not aware of the sale of the hybrid instrument.

4. Conclusion

In Swiss tax law, the tax treatment of hybrid financial instruments and particularly of debt instruments with no fixed right to redemption is subject to a special regulation summarized in a new Circular of the federal tax administration. The key features in this regard are:

- The possibility to use a bifurcation approach, both for Swiss direct taxes levied on residents and for the Swiss withholding tax, which is (at least partially) a final tax for non-residents;
- The possibility for individuals to realize a tax exempt capital gain on the option component of transparent hybrid instruments, either at redemption or upon a transfer of the instrument;
- The possibility for individuals to realize a tax free capital gain on the bond component of transparent hybrid instruments, provided it does not qualify as an original issue discount bond and it is sold before maturity, instead of being redeemed by the issuer;
- The possibility for Swiss banks to issue these hybrid instruments through

their foreign branches or affiliates, in order to avoid the Swiss withholding tax on the bond component of such hybrid instrument;

- The possibility for issuers to deduct all the costs linked with such a financing instrument.

No development of the legislation is to be expected in the near future as to the treatment of these products. When such a development is envisioned, one can hope that two changes be made.

The first change needed, which would simply need a change in the Circular, is the method used for the splitting of the capital gain between the option component and the bond component. The approach could be more accurate than the one currently used, which consists simply in subtracting from the market value of the entire hybrid instrument the bond component, which is valued, for the remaining outstanding period, with the actual yield to maturity at the time of the bond issue, plus or less the change in the interest rates on five year swap contracts. It would be much more precise to use the actual interest rate applicable (i) to the debtor at the time of valuation and (ii) for the actual remaining period up to maturity. This method would reduce the risk of characterizing a capital gain on a bond component as a capital gain on an option strategy, or vice versa.

The second change, which would require a change of law, relates to the method used for the calculation of interest income on the bond component if it is qualified as an original issue discount bond. In fact, since the entire capital gain realized on such a bond is characterized as interest income, it includes not only the accrued interest since the bond issue, which is appropriate, but also true capital gains arising from a foreign exchange gain, or a fall in interest rates. It would be much more adequate to use the yield to maturity upon issuance of the bond for the valuation of the amount of the capital gain arising from accrued interest, and thus needs to be characterized and taxed as interest income; in such a case, the amount of the capital gain arising from a foreign exchange gain or a fall in

interest rates could be characterized as a tax exempt capital gain. ≡

Notes

- 1 Circular n. 4 of April 12, 1999, covering the tax treatment of bonds and derivative instruments under the direct federal tax law and the withholding tax law. Some authors argue that since January 1st 2001, the federal circulars also have an impact on the cantonal and municipal tax treatment of transactions, due to the full entry into force of the federal harmonization law.
- 2 The Circular, § 1 p. 3; § 3.4 p. 9-11.
- 3 The Circular, § 1 p. 3.
- 4 In the past, it was necessary to prove that the investor had the choice to buy or sell (i) the combined hybrid instrument (bond cum option), (ii) the bond component (bond ex option) and (iii) the option component (warrant).
- 5 The Circular, § 1 p. 3.
- 6 Purchase price, sale price, reimbursement price of the bond component and the option component. The Circular, § 4.2 p. 12.
- 7 This duty is actually performed by Telekurs, a financial news company, on a daily basis.
- 8 For example, because upon a transfer of the hybrid instrument, nobody has identified the value of each component of the hybrid instrument. The Circular, § 4.2 p. 12.
- 9 The Circular, § 3.4.1 p. 9-10; § 3.6 p. 11.
- 10 At the time of issuance, the first step of this approach is the discounting of the fixed cash flows linked to the bond component (coupons and redemption value), at the appropriate discount rate corresponding to an ordinary debt of the actual issuer (same maturity dates, same currency, same insolvency risk of the debtor). This will give the fair financial value of the bond component. The second step is the determination of the fair financial value of the option component, by simply deducting the financial value of the bond component from the fair market value of the combined hybrid instrument, which is the total issue price. The Circular, § 3.4.1 p. 9-10; § 3.6 p. 11.
- 11 At the time of a subsequent transfer of the hybrid instrument, the approach is exactly the same as the one used at the time of issuance, except for one element: the determination of the discount rate which will be used for the calculation of the financial value of the bond component. This discounting rate will be (i) the original yield to maturity of the bond component, at the time of issuance of the hybrid instrument, after (ii) the deduction/addition of any fall/rise in interest rates since the date of issuance. The precise amount of rise or fall in interest rates since issuance will be determined by the comparison of interest rates on the Swap markets, for five year maturity contracts, at the day of issuance and at the valuation day. The Circular, § 3.4.1 p. 10; § 3.6 p. 11.
- 12 Includes the tax information related to all domestic and foreign securities listed in a Swiss stock exchange. The Circular, § 4 p. 12.
- 13 The Circular, § 1 p. 3.
- 14 The Circular expressly covers reverse convertibles and bull and bear spreads (under § 2.3.3 p. 6 and § 3.6 p. 11), but no credit linked notes.
- 15 However, instead of being paid entirely upfront, the payment of the option premium will be spread over the life of the bond, and paid together with the coupons, at the same value dates.
- 16 It must be emphasized however, that the cash flows of a same hybrid instrument can be created in many different ways. For example, a reverse convertible can be created either (i) through the combination of (a) a bond and (b) a put sale or (ii) through the combination of (a) a put sale and (b) a cash collateral or (iii) through the combination of (a) a cash collateral, (b) a forward purchase of the underlying and (c) a call sale of the underlying.
- 17 Maturity lower than one year.
- 18 Case of the reverse convertibles and credit linked notes.
- 19 Bull bond.
- 20 Bear bond.
- 21 See Part 1, 2.1.1 d).
- 22 See Part 1, 2.1.1 in fine.
- 23 Swiss Audit Manual, N. 2.38131 p. 354.
- 24 In such a case, the entire portfolio will generally be valued at the average fair market value of the last thirty days before the closing of the books, the net loss or gain being credited to the profit and loss account.
- 25 Corporations may not, except in case of a bankruptcy situation, book an unrealized capital gain.
- 26 Directives of the federal banking commission on bookkeeping § 52 p. 15.
- 27 Directives of the federal banking commission on bookkeeping § 53 p. 16.
- 28 Directives of the federal banking commission on bookkeeping, § 17 p. 4.
- 29 The Circular, § 1 p. 1 and § 3.6 p. 11.
- 30 Art. 4 § 1 a WHTL.
- 31 The Circular, § 3.6 p. 11.
- 32 The Circular, § 3.6 p. 11.
- 33 See Part 1, 3.1.1.
- 34 See Part 1, 2.2.2 in fine.
- 35 Generally, the redemption price of the reverse convertible bond corresponds to the issue price of the entire hybrid instrument. In case of a capital protection of the bondholder through a put option embedded in the hybrid instrument, a clear distinction is made between the redemption price of the bond and the strike price of such embedded put option.
- 36 Art. 14 WHTL Decree. Subjektives Herkunftsprinzip. Applicable weather this difference is due to an issue discount or to a reimbursement premium.
- 37 The Circular, § 3.2 p. 8.
- 38 The Circular, § 3.2 p. 8.
- 39 Net present value of the option premiums paid by the debtor to the hybrid instrument holder.

- 40 Short term hybrid instruments like reverse convertibles with a maturity lower than a year, with no guarantee of the issuer on any payment, are characterized as having exclusively an option premium component, with an upfront payment of the option strike price, which means that the entire difference between the (fixed and lower) issue price and the (variable and higher) redemption price will be qualified as a tax exempt capital gain (The Circular, Attachement III, § 2 p. 1).
- 41 The Circular, § 3.6 p. 11 and 3.4.2 p. 10.
- 42 Art. 14 WHTL Decree. Subjektives Herkunftsprinzip. Applicable whether this difference is due to an issue discount or to a reimbursement premium.
- 43 The Circular, § 3.2 p. 8.
- 44 The Circular, § 3.2 p. 8.
- 45 The Circular, § 3.2 p. 8.
- 46 The Circular, § 3.2 p. 8.
- 47 The Circular, § 3.2 p. 8.
- 48 The Circular, § 3.6 p. 11 and 3.4.2 p. 10.
- 49 The Circular, § 3.6 p. 11 and 3.4.1 p. 9.
- 50 The same tax treatment will be applied to the entire proceeds from the sale of short term hybrid instruments like reverse convertibles with a maturity lower than a year, and no guarantee of the issuer on any payment, since such transactions are qualified as having exclusively an option premium component, with an upfront payment of the option strike price.
- 51 The tax exempt capital gain will include the accrued coupon, which does not correspond to a taxable interest since the payment is made by the future holder and not by the debtor (Subjektives Herkunftsprinzip).
- 52 The Circular, § 3.6 p. 11 and 3.4.1 p. 9.
- 53 Except in the case of deduction of losses on OID (instruments or components) against capital gains on other OID (instruments or components), in the same tax period. The Circular, § 3.2 p. 8.
- 54 As we have seen above, generally, the redemption price of the reverse convertible bond corresponds to the issue price of the entire hybrid instrument.
- 55 The Circular, § 3.4.1 p. 10.
- 56 The Circular, § 3.2 p. 8.
- 57 The Circular, § 3.6 p. 11 and 3.4.2 p. 10.
- 58 Which is rarely the case for non transparent reverse convertibles subject to an integration approach, since the option premium will enhance the direct (periodic) yield of the bond.
- 59 The Circular, § 3.2 p. 8.

RESUME

Traitement fiscal des instruments financiers combinés

En droit suisse, le traitement fiscal des instruments financiers combinés, en particulier celui des obligations sans capital garanti à l'échéance, tels que les reverse convertibles, est régi par la circulaire n° 4 de l'Administration fédérale des contributions, du 12 avril 1999.

En résumé et en substance, les éléments essentiels de ce traitement fiscal sont les suivants, pour l'impôt sur le revenu des personnes physiques et pour l'impôt anticipé:

- Une approche de bifurcation sera appliquée en cas d'instruments financiers transparents, avec pour conséquence que chacune des composantes de l'obligation combinée (partie option, partie obligation) suivra son traitement fiscal propre.
- En l'absence de transparence, ce sera une approche d'intégration qui sera appliquée, le résultat sur la partie option de l'obligation combinée étant alors qualifié fiscalement de rendement (variable) d'obligation.
- La transparence ou l'absence de transparence de l'obligation combinée dépendra de la preuve apportée

ou non par l'émetteur, physiquement ou analytiquement, de l'existence de deux composantes séparées de l'obligation combinée (option et obligation).

- Par voie de conséquence, en cas de produit transparent, les personnes physiques détenant les obligations combinées dans leur fortune privée auront la possibilité:
 - a) sur la partie option de l'instrument financier, de réaliser un gain en capital exonéré de l'impôt sur le revenu et de l'impôt anticipé, (i) lors de l'encaissement de chaque coupon annuel, sur la partie de ce coupon qui représente la rémunération de l'investisseur pour l'option vendue à l'émetteur, ainsi que, (ii) lors de la revente de l'obligation combinée à un tiers, sur la plus-value éventuelle de la partie option de l'obligation combinée;
 - b) sur la partie obligataire de l'instrument, de réaliser une plus-value exemptée de l'impôt sur le revenu en cas de vente à un tiers, si cette partie obligataire ne qualifie pas d'obligation à intérêt unique prédominant.

- En cas de produit non-transparent, le résultat sur la partie option de l'instrument financier sera qualifié d'intérêt variable d'obligation, de sorte que chaque coupon annuel payé à l'investisseur sera intégralement soumis à l'impôt sur le revenu ainsi qu'à l'impôt anticipé et ce, même pour la partie de ce coupon qui correspond au prix de l'option vendue par l'investisseur à l'émetteur. En revanche, et à la condition que l'on ne soit pas en présence d'une obligation à intérêt unique prédominant, toute plus-value éventuelle réalisée par l'investisseur lors de la vente de l'obligation combinée à un tiers sera qualifiée de gain-capital exonéré, que ce gain soit réalisé sur la partie option ou sur la partie obligation de l'instrument combiné.
- Les émetteurs suisses auront la possibilité de déduire tous les coûts liés à l'émission de ce type d'obligation combinée.
- A certaines conditions, les émetteurs suisses auront la possibilité d'éviter l'impôt anticipé en faisant émettre l'instrument financier par le biais d'une filiale ou d'une succursale située à l'étranger. NM