

Taxation of Investment Derivatives

Chapter 1

Introduction

1.4. Methodology

A comparison of two or more tax systems often provides a logical approach to the essential tax issues within selected countries. As a result, doctoral level studies and other major studies on international taxation are regularly based on *comparative analysis* (comparative method). A comparative study compares and analyses different tax systems and makes its own conclusions from the resulting components. Furthermore, a *traditional legal study*, as Helminen classifies her dissertation¹, generally evaluates *primary sources*, such as actual tax law provisions and case law. The concept *secondary source* consists of legally not binding materials such as handbooks and articles in different tax journals.

This study focuses on three universal tax issues, namely valuation, timing and the taxation of unrealised gains. The study also refers to tax legislations and the tax practices of different countries, and, consequently, the comparative method plays an important role in the study. For instance, I compare the tax practices in different countries with the intent to find similarities and differences in the tax treatment, especially considering that the underlying components, single and often specified financial derivatives, are basically identical. While this study does not deal with individual tax treaties or bilateral transactions, I will scrutinise the OECD Model in order to highlight the underlying principles of the given recommendations, particularly as concerns interest income and capital gains. Since primary legal sources do not regularly include comprehensive provisions or guidance on the taxation of financial derivatives, I continuously rely on secondary source material in this dissertation. Moreover, I try to stay, at least to some extent, an arm's length from traditional legal studies with the aim of providing different perspectives from finance, accounting and economics. Ultimately, I still consider this study to be a dissertation in tax law.

Studies on taxation may follow the *doctrinal concept* or a *country-by-country basis*.² Viherkenttä chooses to follow the doctrinal concept rather than a country-by-country basis³, and actually succeeds fairly well in his endeavour. His table of contents is practically free from country presentations and the text describes and analyses the doctrines without constant country presentations. A doctrinal approach obviously

¹ Helminen, 1999, p. 8.

² The doctrinal concept primarily concentrates on one tax issue at a time, whereas the country-by-country basis presents all relevant tax issues within one country.

³ Viherkenttä, p. 5.

diminishes repetition, which easily takes place in studies done on a country-by-country basis. Helminen, for example, follows the doctrinal approach but reviews each domestic law separately for each tax issue and cannot, therefore, avoid repetitive items in her dissertation.⁴ From another point of view, this type of *doctrinal country-by-country approach* forces the author to really study the tax practices of the selected countries. This is precisely what Helminen is conscientiously doing.

Van Raad's dissertation with an exceptionally short introduction (1.5 pages) has been my benchmark for achieving a short and non-repetitive style, precisely the style I have tried to follow in this study.⁵ However, the Nordic tradition still seems to favour '*all-inclusive*' dissertations with a heavy descriptive part plus an analysis.⁶ Consequently, this study is also fairly heavy on descriptive issues. A dissertation on a fairly uncommon topic may need more background information than a dissertation on a traditional and established tax issue. A traditional tax issue often calls for a fresh viewpoint, but such a study may still be based on earlier studies in the same field.

1.5. Previous studies

The taxation of financial instruments and, in particular, financial derivatives has been a challenging topic during the last two decades, primarily because of the continuously developing instruments and the undeveloped rulings. As a result of the inconsistencies, financial engineers have had good opportunities to gain from this situation. The engineers try to stay at least one step ahead of the tax authorities and constantly provide new instruments to their clients. The instruments often include some kind of tax incentive. As a result, financial instruments have received a fair amount of attention among tax practitioners and academics, especially in the US.

My dissertation tries to partly fill the void concerning major studies on financial derivatives. I know of only two doctoral level studies on the taxation of financial derivatives in the selected countries. The English-speaking world, however, cannot get too much from these studies since *Woywode* writes in German and *Haapaniemi* in Finnish. *Woywode* (2004) focuses on financial instruments and the OECD Model while *Haapaniemi* (2006) scrutinizes share-based incentive schemes (employee stock options) from the Finnish perspective. It is true that stock options together with ordinary bonds or zero coupon bonds are fundamental components of investment derivatives, but employee options and other investment options serve somewhat different purposes than investment derivatives. Share-based incentive schemes are extensions of salaries and relate to employments, whereas investment derivatives are available to every person interested in such investment alternatives. As a result, employee options have somewhat different

⁴ See 'Table of Contents' in Helminen, 1999.

⁵ Barenfeld chose an opposite approach with his introduction of 41 pages.

⁶ Viherkenttä is an exception to this tradition with only 236 pages. Moreover, some Swedish tax academics have questioned the meaningfulness of the descriptive parts in dissertations. Bergström et al. recommend a maximum length of 300 pages for dissertations. As a rule, the doctoral candidates should concentrate on new views and attitudes, their own analyses, and avoid descriptive exercises which rather belong to tax handbooks.

legislative needs than investment derivatives.⁷ Furthermore, it is interesting to note the low amount of common elements between Haapaniemi's 440 text pages and my own study. The non-correlation is probably the result of different target groups, or maybe it is an indication of the broad extent of the financial derivatives, and proof that doctoral dissertations have a narrow but extensive focus.

There are, however, some other studies and handbooks on financial instruments. One of the first major studies in the field is OECD's *Taxation of New Financial Instruments* (1994), which compares the taxation of financial instruments in different OECD countries. The study concentrates on three basic derivatives and one traditional financial instrument.⁸ Soon after the OECD 1994 study, some European tax academics published a fairly comprehensive study on the tax treatment of financial instruments in their home countries. The *Tax Treatment of Financial Instruments* (1996) focused on the tax issues in France, Germany, the Netherlands and the United Kingdom.⁹ OECD 1994 and the latter study have played a fundamental role in my dissertation in many ways, especially at the beginning of the study process. In addition, the books of Mannio, Tikka M. & Haapaniemi and Rutberg *et al.* have been essential sources on relevant tax issues in Finland and Sweden. Rutberg *et al.* filled a similar gap in terms of the tax treatment of financial instruments in Sweden, as did Tikka M. & Haapaniemi in Finland. Furthermore, *Kramer* (the US tax environment) and *Southern* (the UK tax environment) are responsible for the most essential handbooks in the field. Their volumes have an analytical approach, and consequently, the volumes are not just law texts written in a simple and user-friendly format, but are actually a type of hybrid between a handbook and tax research.

1.6. Outline of the study and materials

Each chapter except the final remarks incorporates a separate subchapter reviewing the content and outline of the chapter. Also, the text flow occasionally pauses for a subchapter, *concluding remarks*, containing a summary of the preceding main issues and conclusions.

Chapter 2 focuses on financial instruments and approaches the issue from the perspective of finance theory rather than that of taxation. However, a significant part of the information in Chapter 2 comes from the tax articles and books, since several authors have described the relevant financial instruments as background information for their analyses. The reliability of these presentations seems, however, to be high. *Chapter 3* focuses on the main tax principles and concepts. Because of the importance of the accrual method, an integral part of this study deals with the concept of income and the idea of comprehensive income taxation as presented by Robert M. Haig (1921) and Henry C.

⁷ For instance, Finnish Income Tax Act has separate provisions for employee stock options (TVL 66) and standardised options (TVL 45.3).

⁸ OECD 1994 deals with stock options, financial futures, interest rate swaps and deep discount bonds (zero coupon bonds).

⁹ *David, C., Michielse, G., Theisen, M.R., Wenz, M. & Tiley, J. Tax Treatment of Financial Instruments.* Kluwer Law International, The Hague, 1996

Simons (1938). It is interesting to note that the texts continue to be highly relevant. *Chapter 4* focuses on the taxation of interest income and capital gains. In addition to the domestic tax issues in the selected five countries, Chapter 4 evaluates the OECD Model, which describes the standards of tax treatment in the international context. The OECD Model provides a solid base for the analysis of the taxation of interest income and capital gains. *Chapter 5* evaluates accounting rules concerning financial derivatives. The chapter especially focuses on IAS Standards and the relationship between accounting and taxation. Because of the accrual method and its annual value changes, this dissertation concentrates heavily on the accounting concept of *fair value*.

Chapter 6 concerns common tax issues and different approaches related to the taxation of financial derivatives. A significant part of the discussion concerns different taxing methods and proposals, mostly derived from US tax literature. The US perspective is evident, but the articles are still important for universal purposes. The most important US articles for my purposes are probably those of *Cunningham & Schenk, Keinan, Shuldiner, Warren* and *Weisbach*. Moreover, the findings and conclusions of OECD 1994 are elemental in Chapter 6.

Chapter 7 evaluates the taxation of investment derivatives in the selected countries, including a review on the taxation of zero coupon bonds and stock options. Similar to the materials in Chapter 2, the articles of the journal *Derivatives & Financial Instruments* (DFI) have been instrumental in many ways in Chapter 7, especially those of *Feder, Lamon* and *Trapp*. In principle, articles are always secondary sources in taxation, but in the case of financial derivatives, the undeveloped primary sources (actual law provisions and case law) usually provide inadequate support for tax issues. Accordingly, DFI articles as well as other tax articles have been significant sources for my study. In addition to a considerable number of articles, the US doctrine is also gained from comprehensive handbooks on financial instruments. For instance, Kramer's three binders on financial products were an important source for this study. Furthermore, the *International Fiscal Association* (IFA) discussed financial derivatives and hybrid financial instruments in its 1995 and 2000 Congresses in Cannes and Munich. As usually, the IFA Congress books consisted of general reports and then detailed presentations on the instruments and the tax practices in several countries. *Chapter 8* discusses the findings of the earlier chapters, and finally, *Chapter 9* contains the final remarks.

This study intends to review the legislations and practices valid as of 1 January 2007. I will also point out that the study is not a law book or tax handbook in the sense that it would include all exceptions to the main rules. The purpose is rather to present the main rules and relevant provisions in order to provide a solid framework for the derivatives discussion, and to enable the reader to understand how the respective tax systems work and how the specified financial instruments are treated in the selected countries.