The taxation of equity-linked notes

Commentators remain cautious about the Inland Revenue Department’s stance that a hybrid instrument be treated as one single instrument for tax purposes. By Tracy Ho and Grace Tang

As many companies and individuals in Hong Kong now buy equity-linked notes from authorized institutions such as banks for investment or other purposes, tax issues arise from the fact that the note is a hybrid instrument consisting of two components: a note of deposit and a contractual option right or obligation in relation to certain underlying securities to which the note is linked.

Take a note with a nominal value of HK$3,000,000 issued on 1 October 2010 at 98.92 percent of its nominal value maturing on 12 November 2010 (that is, 43 days in duration) as an example. The buyer deposited a sum of HK$2,967,600 (that is, 98.92 percent of HK$3,000,000) with the authorized institution on the issue date and expected to receive back HK$3,000,000 on the maturity date, giving him an annualized yield of 9.26 percent.

But the terms for the deposit are conditional on the performance of an underlying security listed on the Hong Kong stock exchange, to which the note is attached. The following two scenarios show the difference.

Contrast scenarios

Scenario 1: At or above strike price
If the closing price of the shares is HK$110, which is above the strike price of HK$100, the holder will receive the nominal sum of HK$3,000,000 of the note in cash and earn a return or discount of HK$32,400 (HK$3,000,000 - HK$2,967,600).

Scenario 2: Below the strike price
If the closing price of the shares is HK$90, which is below the strike price of HK$100, the holder will receive the nominal sum of HK$3,000,000 of the note in kind.
Where applicable, which tax rules should be applied to determine the source of that portion of the return or discount in the nature of interest income...? Can the note be defined as a certificate of deposit and, therefore, should the taxability of the income from the disposal or settlement of the note be governed by certain provisions of the Inland Revenue Ordinance applicable to the certificates?

Tax issues
Tax issues are raised from the above two scenarios: Under scenario 1, is the return or discount income of HK$32,400 earned on the equity-linked note in the nature of interest, or should it be dissected into possibly interest and other types of income such as an option fee due to the holder?

Official views
The Inland Revenue Department views the discount of HK$32,400, or its portion, in the above example to be interest income because the difference between the nominal value and the purchase price represented consideration for the use of money paid by the authorized institution.

But the IRD also noted that other factors have to be considered in determining whether the entire discount is wholly made up of interest, or can possibly be dissected into interest and other types of income. These include all the relevant terms of the note and the permitted accounting treatment.

Regarding the source of the interest component of the return, the taxation authority indicates that for a person who bought the note for investment purposes, the “provision of credit” test would be used to determine the issue. As a result, if the funds for the purchase of the note were first deposited into an overseas bank account of the issuing institution, the interest would be regarded offshore in nature and non-taxable in Hong Kong.

If the notes are bought for trading purposes, the “operations” test, or an examination of all the relevant profit-generating activities including the place where the note was traded, would be used to determine the source of the interest income.

Even if the interest is regarded as onshore, the IRD accepts that for deposits placed with a bank, any tax payable on the interest component would be exempt in Hong Kong under the Exemption From Profits Tax (Interest Income) Order (Cap. 112T) unless it is a financial institution that receives the interest and does not meet certain other conditions.

A certificate of deposit?
If the note is not transferrable by delivery and is not a bill of exchange, it would not be a
The effect and implications of the IRD’s general position that a hybrid instrument be treated as one single instrument for tax purposes need to be carefully considered and understood. This is particularly the case when the assessing practice is applied to an equity-linked note transaction with constituent components of different natures, as a deposit component is more akin to an investment.

certificate of deposit according to the Inland Revenue Ordinance and so the provisions contained in sections 15(1)(j), (k) or (l) would not apply to it, according to the IRD. But if it is transferrable by delivery, the IRD will normally regard it as a certificate of deposit barring other features suggesting otherwise.

Nature of loss
Disregarding the source issue, the IRD has noted that whether a gain or loss from the disposal of an asset is taxable or deductible depends on whether it is a capital or revenue asset in nature. This requires an examination of the surrounding circumstances, including the risk profile of the subject instrument and the frequency or number of the same or similar transactions.

Because there are other factors determining the capital-versus-revenue nature of an asset, even if a person held only one note, it would not necessarily follow that the loss on the settlement of the note would be non-deductible capital loss. But if a person is not engaged in the trading of equity-linked notes, the loss would not be tax deductible.

As a single instrument
The IRD states in paragraph 42 of its practice note no. 42: “For tax purposes, the nature (that is, capital or revenue) and locality of profit and loss of the hybrid instrument are determined on the basis that it is one single instrument. In other words, the nature and locality of profit and loss from the embedded derivative and the host contract should always be the same.”

The IRD has subsequently elaborated that for tax purposes, it would not normally accept that the income and loss of the hybrid elements are of a different nature: That is, one item is capital whereas the other is revenue, or one item is offshore income whereas the other is an onshore loss.

That means in this example, the capital-versus-revenue characterization of the income from the deposit would have to be the same as that for the income or loss from the option contract. Similarly, the onshore-versus-offshore nature of the income from the deposit would have to be the same as that for the income or loss from the option contract.

Comment
Although acknowledging the possibility, the IRD has not stated explicitly under what circumstances the return on an equity-linked note might be dissected into interest or other types of income.

Going back to the earlier example, some commentators may argue that the return on a note with terms similar to those in the sample case is clearly composed of interest and option fee components.

If the pure deposit of HK$2,967,600 placed with the same authorized institution on the same terms at the same time would only give an annual interest yield of 2.26 percent, the return on the note in scenario 1 could possibly be viewed for tax purposes as comprising an annual interest yield of 2.26 percent and an option fee income of the balance of the total annual yield of 7 percent (that is, 9.26 percent - 2.26 percent).

As such, and since the interest component of the return can normally be readily ascertained by reference to a pure deposit placed under the same circumstances, a dissection of the return should be made.

The effect and implications of the IRD’s general position that a hybrid instrument is to be treated as one single instrument for tax purposes need to be carefully considered and understood.

This is particularly the case when the assessing practice is applied to an equity-linked note transaction with constituent components of different natures, as a deposit component is more akin to an investment.

The taxation of financial hybrid instruments is a complicated matter and taxpayers should seek professional tax advice where necessary.