The Taxation of Specific Hybrid Instruments

This paper focuses on the tax treatment of some specific hybrid financial instruments and summarizes the basic tax principles applicable. Swiss withholding tax aspects will not be analysed.

For a few years, private investors have had a large choice of hybrid instruments issued by banks and other financial intermediaries available to them. The taxation of income derived from this kind of investments is all but clear. It is, however, crucial for private investors to know the tax treatment that may apply to their investments. Depending on the applicable tax treatment, the performance of hybrid instruments can vary significantly.

I. Basic tax principles

Switzerland is a federal State with a direct tax system composed of three different levels of taxation: (1) federal, (2) cantonal and (3) communal. Swiss resident individuals are taxed on their worldwide net income (arising from domestic and foreign sources). Hence, federal as well as cantonal/communal tax laws foresee that any recurring or non-recurring income received by a taxpayer is subject to direct income tax. However, capital gains realised on private movable assets are exempt from federal and cantonal/communal income taxes.

It should be noted that the above-mentioned tax exemption is not applicable where the taxpayer is deemed a professional trader (because managing his movable private assets actively and with the same professionalism and intensity as a professional trader). In such a case, the private investor is deemed to conduct a business so that both investment income and capital gains are subject to income tax. Where the assets are viewed as a private investment, the distinction between investment income (which is taxable) and capital gains (which are tax exempt) is fundamental, in particular when considering the taxation of hybrid instruments.

1. Interest from ordinary debt instruments

As a rule, any income derived from a debt instrument (loan, bank account, bonds, etc.) is subject to income tax. From a tax point of view, interest is taxable provided that a payment (1) arises from the **debtor** in favour of the private investor (creditor) and (2) does not represent a reimbursement of the principal amount (*i.e.* exceeds the nominal value).

Hence, where a private investor sells a bond, the part of the selling price that includes accrued interest is not considered as taxable income but as an exempt capital gain. This particular tax treatment can be explained by the fact that the payment is not made by the debtor but by the new creditor. In other words, capital gains realised upon disposal of a bond prior to maturity are tax exempt. However, the reimbursement received at maturity of the ordinary bond is qualified as taxable interest: in such a case, the payment is made by the debtor to the private investor and exceeds the value of the principal.

“A private investor should avoid non-transparent reverse convertibles.”

The above-mentioned rules are subject to an important exception in connection with original issue discount bond (hereinafter “OIDB”) or bonds with redemption premium (hereinafter “BRP”).

2. Interest from zero-coupon bonds, discount bonds and bonds with redemption premium

It is usual for bonds to combine a below market periodic interest coupon with either OIDB or BRP (*i.e.* mixed bonds). The private investor thus receives a direct yield (periodic coupon yield) and an indirect yield corresponding to the premium received upon maturity (single interest payment).

From a tax point of view, it is crucial to determine whether the periodic coupon or the single interest component is predominant. Where a bond qualifies as a bond with predominant single interest payment, the tax law provides that the capital gain realised by the private investor upon alienation or repayment of the bond is fully taxable. This tax treatment is applicable despite the fact that the “single interest component” is paid by the buyer of the bond and not by the debtor. According to the current practice of the Federal Tax Administration (hereinafter “FTA”) published in a recent circular, a bond has predominant single interest payment when less than 50% of the yield to maturity (combining direct and indirect yield) consists of periodic interest coupons. Such qualification is made at the time of issuance on the basis of a financial calculation. Price movements occurring after the issuance day of the bond do not modify the fiscal qualification.

> Mr. Arthur buys a zero-coupon bond at issuance. The bond features may be summarised as follows:
> - Issuance price: 78.35%
> - Principal amount: 100.00%
> - Term: 5 years
> - Interest coupon: 0.00%
>
> After three years, Mr. Arthur sells the bond to Mr. Jones for 91.5%. Mr. Jones would like to keep the bond until redemption.
> From a tax perspective, this bond must be qualified as a bond with predominant single interest. As a consequence, Mr. Arthur is taxable on 13.15% (91.5–78.35) whereas Mr. Jones will be taxable on 8.5% (100–91.5).

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Based on the above-mentioned rules, the zero-coupon bond is obviously a bond with predominant single interest as illustrated in the example.

To sum up, the compensation paid by the issuer for a mixed bond with predominant single interest payment is subject to income tax at the time the bond matures. The same tax treatment applies in case of disposal prior to maturity. In the latter situation, the difference between the selling price and the acquisition price (or issuance price) is subject to income tax.

II. Taxation of hybrid instruments

As a rule, hybrid instruments combine a bond with a derivative product. It must be underlined that the tax treatment of each hybrid instrument has to be carefully analysed.

1. Classical convertible bond and option bond

When a private investor holds a classical convertible bond, he is entitled (but not obliged) to convert the underlying debt into shares of the issuing company or of another company during a limited period of time. With classical option bonds, the private investor has a separate option that may be exercised for shares in addition to the repayment of the bond.

According to the above-mentioned circular of the FTA, some conditions have to be met in order for a bond to qualify as a classical convertible bond or as a classical option bond, notably: (i) the issuer of the bond has to be a Swiss company and (ii) the option or conversion right attached to the bond should entitle the private investor to acquire newly issued shares in the Swiss company issuing the bond or in a Swiss or foreign affiliated company. Provided these conditions are met, the tax treatment is very advantageous. Indeed, a sale or redemption of a classical option bond or of a convertible bond by a private investor will never trigger income tax. Only the periodically paid interest is considered as taxable income for the private investor.

2. Other convertible bonds and option bonds

Where convertible bonds and option bonds are not classical but "transparent" (*i.e.* the two components of the hybrid instrument can be clearly identified and valuated separately), one should further examine whether or not the bond qualifies as an OIDB or as a BRP with predominant single interest. In case the answer is positive, both the periodic interest coupon and the capital gain are subject to income tax. In case the answer is negative, the capital gain realised upon sale of the bond prior to maturity is tax exempt. In both cases, reimbursement proceeds are taxable.

In case the hybrid instrument is neither classical nor transparent, the private investor shall be taxable on any received amount (periodic interest coupon, capital gain arising from the sale of the redemption of the bond).

3. Reverse convertibles

A reverse convertible may be characterized as a combination of a bond and of a put option on an underlying commodity (typically on a specific share). In broad terms, the private investor acquires a bond from the debtor and simultaneously sells him a put option in relation with the underlying asset. Depending whether the debtor exercises the put option or not, the private investor either receives a cash repayment or acquires the underlying commodity (instead of obtaining repayment of the cash invested).

From a tax point of view, the treatment of reverse convertibles is similar to the one of non-classical convertible bonds and option bonds. Assuming the reverse convertible is "transparent" (*i.e.* the bond part of the product can be isolated from the option part), the option premium paid by the issuer to the private investor is exempt from income tax whereas interest related to the bond part of the product are taxable. Should the private investor hold "non-transparent" reverse convertibles, any amount paid by the issuer is fully taxable (irrespective of the existence of an option component). For this reason a private investor should avoid acquiring non-transparent reverse convertibles.

III. Conclusion

The rules summarised above are quite complex. The circular issued by the FTA explains the tax treatment of the main hybrid instruments in broad terms and clarifies various tax issues in relation with this kind of financial products. The taxation is very advantageous when it comes to transparent hybrid instruments. This qualification, however, requires an important administrative burden both from the issuer and from the bank in charge of the management of the private investors' assets.

Thierry De Mitri is a Partner of Piaget & Associés since 2001. The certified tax expert holds a law degree from the University of Geneva and a Certificate in Management Studies from HEC Lausanne. Mr. De Mitri teaches tax law at several high level banking and accounting schools.