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# TAXATION OF EQUITY DERIVATIVES AND STRUCTURED PRODUCTS

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TONY RUMBLE

with

Mohammed Amin  
and Edward D Kleinbard

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# FOREWORD

Financial derivatives are practical examples of innovations which touch the lives of many of us. They are used by the managers of everyday savings and superannuation plans, as well as by sophisticated individual investors who explicitly use them to generate arbitrage profits. Yet the theory and pricing models which drive modern derivative finance date only from the early 1970s, when the Black–Scholes model, and its variants, were first conceived.

Coincidentally, the corporate and taxation regulation of derivatives, whether they are used on their own or as part of a package known as a structured product, has failed in many ways to keep pace with these financial developments. Of course, many Western economies have embarked on regulatory reform programmes, and have as a result modernized key aspects of regulation. Progress has not been uniform, however, and as a general rule it can still be said that inappropriate regulation prevails in many countries. This can be bad for business and investors, as well as bad for the Revenue.

This book has its origins in two critical questions which were kindly posed to me, in relation to the fundamental nature of derivative finance. The first was a question put by Roger Paul, of the Australian Taxation Office, probably as early as 1990, when he asked rhetorically, ‘what is the difference between debt and equity?’ The answer, of course, is not a lot; and at one level of abstraction, there is no difference – they both provide finance and are ephemeral in their prospect of repayment. It might be argued that debt returns are fixed and equity returns are variable, but in this scenario, how do we differentiate between contingent debt and redeemable preference shares? Roger’s question led to the idea that a tax system which differentiated between debt and equity – or which treated derivatives as an afterthought – might be unsound, a

proposition which was confirmed as I sat in the lecture theatres of the University of Sydney Law School, as a (relatively) young postgraduate student.

At the University of Sydney I was fortunate to be taught by three scholars whose teaching has followed me since then: Professor Richard Vann, Professor Graeme Cooper and Professor Bob Deutsch. Richard in particular taught in the close analytical style pioneered in Australia by Professor Ross Parsons, who I was fortunate to be acquainted with briefly during his later years. The style was more than black letter law, for it emphasized a search for the reasons behind the legislation – but it also proceeded on the assumption that taxes and tax legislation ought to make sense and be construed with precision, so as to give effect to core notions of income taxation. The classes they taught supplemented the practical training I received as a lawyer and then investment banker, and my gratitude to their fine minds and selfless attitude to teaching and learning is huge. Bob in particular encouraged my thinking about derivatives, and ultimately led to me joining the academic programme at the Australian Taxation Studies Program (ATAX) in the Faculty of Law, at the University of New South Wales.

At ATAX my immediate gratitude must be acknowledged to Professor Yuri Grbich. Yuri encourages a vigorously inquiring mind, but without any allowance for arrogance or pedantry. As founding director of ATAX, Yuri was kind enough to allow me to teach and write in my areas of interest, and always had a perspective on difficult issues. To my ATAX colleagues, Chris Evans, Binh Tran Namh, Mike Walpole, Neil Warren, Paul and Tania Serov, Colin Fong, Helen Chapman and the rest of the team, many thanks.

This book had its origins in the PhD thesis I completed while at ATAX. Bob Deutsch was my supervisor and helped the process considerably. In his later role as director of ATAX, Bob once again was kind enough to support my teaching and professional education seminars at ATAX, and continues to be a friend and mentor. Dr Terry Dwyer provided many helpful perspectives on the notions of corporate tax integration which were integral to this work.

As part of my research for the PhD thesis, I found myself reading and returning to the writings of Professor Alvin Warren of Harvard Law School. Alvin was kind enough to correspond with me, and upon finally meeting Alvin at Harvard, I was fortunate to have many of my half-formed ideas crystallized through discussions with him. As we parted, Alvin posed a Socratic question which goes to the heart of the issues discussed in this book.

Alvin's question was deceptively simple and its resolution framed the work in my thesis. Having identified many practical examples, in Australian and US taxes, of how debt and equity were treated differently, Alvin asked simply, why does it matter? The answer, I think, is that it matters where taxpayers are taxed at different rates, and (in the Australian context) where imputation benefits are provided only to resident taxpayers. This conclusion seems to direct the

inquiry towards an attempted resolution of the debt/equity problem, not only within the context of a domestic tax system, but also as it relates to cross-border taxation. Australian reforms have gone a long way towards reducing the domestic problem, and part way towards curing the cross-border problem, and the ongoing work of the government's Board of Taxation and its inquiry into international taxation should help to complete some of this work.

Alvin's *Reporter's Study on Corporate Tax Integration* contained within it mention of the concept of a bondholder credit, which I translated into my proposal for a system of franked debt. Ironically, it was Professor Tim Edgar of the University of Western Ontario who pointed out to me the practical implications for my thesis of the concept of franked debt. Tim is one of the few scholars globally who have devoted attention to the field of taxation of derivative finance, and is also one of the supporters of the ATAX Derivatives Spring Schools, an annual event which has been the occasion for the presentation of much of the work which now appears in this book. Alvin and Tim's work pick up on some of the issues which have also been canvassed by two others whose support and assistance has been invaluable, Malcolm Gammie of Temple Court, London, and Ed Kleinbard of Cleary Gottlieb Steen and Hamilton, New York City. Both Malcolm and Ed have written extensively in the area, and my thanks go also to Ed for agreeing to contribute the US country chapter in this book. Thanks also to Mohammed Amin and Emma Lubbock of PwC UK, Mohammed for his contribution of the UK country chapter, and Emma for her friendship and support during my time as a partner at PwC.

There have been some personal friends and colleagues who have helped and inspired me over the last decade, without whom I am sure this book would never have been thought of or written. Peter Kennedy who taught me the fundamentals of derivatives as we worked on the launch of the Australian warrant market, Greg Stoloff who reminds us that integrity and friendship as well as intelligence are the hallmarks of the true professional and Rod Cox of Blake Dawson Waldron, who has always been there for me.

It has been my aim to work with the regulators towards a common goal of an efficient and equitable tax system, and in particular I would like to acknowledge the support and great intellectual stimulation provided to me by Richard Wood, now a consultant to the Australian Treasury and previously the Treasury team leader on the Taxation of Financial Arrangements project; and from Peter Walmsley, Assistant Commissioner at the Australian Taxation Office. Richard was kind enough to seriously engage the concept of franked debt, and as part of our work together during the government's Review of Business Taxation, Richard's perceptive mind picked the flaws in, and improved the positives of, that idea. Richard's contribution to Chapter 6 is acknowledged. Peter of course is one of the intellectual leaders of the ATO, and has been a friend and professional colleague for some time. In more recent years, Murray

Edwards, Secretary of the government's Board of Taxation, Dick Warburton, Chair of that Board, and John Harvey (also on the Board and the CEO of PwC during my tenure there) have provided great support and encouragement.

Portions of the book have appeared in previous versions as chapters in books I have edited, including *Innovative Financial Products*, *Derivatives Tax Reform* and *Australian Business Tax Reform*. The article 'Franked Debt: A Capital Markets Savings Cure' appeared in the latter book. A previous version of the analysis of convertible preference shares has also appeared in the 1996 Global Special Edition of *Financial Derivatives and Risk Management*, edited by Sajayit Das, whose inspiration is one of the motives for this book. Other articles in which portions of this work have appeared are footnoted and detailed in the references.

Capital management is a key theme of this book and my friend and colleague Chandu Bhindi has provided a sharp focus to my perspective in this area. Dr Justin Wood, then of the Australian Graduate School of Management and now CEO of Barclays Global Investors Australia helped to clarify some of the difficult corporate finance issues. And as part of the great tax reform debate in this country in recent years, Dr Peter Burn, immediate past Assistant Director of the Business Council of Australia/Business Coalition for Tax Reform, as well as Mark Paterson (previously of ACCI), have been good mentors.

Andrea Harthill and Jacky Kippenberger at Palgrave have helped move this book from an idea to reality – thanks for your assistance and encouragement.

Finally, it is fundamentally important for me to record my eternal gratitude to my wife and children, for their inspiration and love. My parents have supported me in my studies and professional career and, without this, the book would not have been written.

Errors are the author's responsibility, and unless otherwise stated, the book reflects the law as at 30 June 2002.

TONY RUMBLE  
Savings Factory  
([www.savingsfactory.com](http://www.savingsfactory.com))  
Aurora Place  
Sydney