



Aggressive Tax Planning based on After-Tax Hedging



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Foreword

Following on from the OECD's report *Corporate Loss Utilisation through Aggressive Tax Planning* (2011), this report describes the features of aggressive tax planning (ATP) schemes based on after-tax hedging as well as the strategies used by countries to detect and respond to those schemes. The report, which draws from schemes submitted to the OECD Directory on Aggressive Tax Planning, also highlights a number of challenges from a compliance and policy perspective.

Risk management and hedging are key issues in corporate management. In certain cases, taxpayers may see an opportunity or a need to factor taxation into their hedging transactions to be fully hedged on an after-tax basis. However, after-tax hedging, while not of itself aggressive, may be used as a feature of schemes which are designed to allow taxpayers to achieve higher returns, without actually bearing the associated risk which is in effect passed on to the government through the tax charge.

This is yet another example of what enhanced cooperation in tax matters can deliver. A number of countries encountered ATP schemes based on after-tax hedging and exchanged information (both spontaneously and on request), also sharing other intelligence on those schemes with other countries involved. This has allowed other countries to, in turn, detect and respond to those schemes. Countries have put in place strategies focusing on spreading knowledge and information regarding these schemes internally within their tax administration. Many countries have also launched projects to examine the extent of the dissemination of these schemes in their countries.

ATP schemes based on after-tax hedging pose a threat to countries' revenue base. Empirical evidence suggests that hundreds of millions of USD are at stake, with a number of multi-billion transactions identified by countries. This type of ATP schemes is used by different types of taxpayers and across various industries. Any country that taxes the results of a hedging instrument differently from the results of the hedged transaction/risk is potentially exposed to such schemes. It is therefore important that countries are aware of arrangements that use after-tax hedging for ATP purposes.

Table of contents

<i>Forewords</i>	3
Executive summary	7
I. Introduction	11
II. Aggressive Tax Planning Schemes based on After-Tax Hedging	13
1. In general	13
2. Hedging transactions: an example	13
3. The effect of the tax system on hedging transactions	15
4. Factoring the tax treatment into the hedging transaction: over-hedging or under-hedging	17
5. ATP schemes based on after-tax hedging	19
III. Strategies used to detect and respond to ATP Schemes based on After-Tax Hedging	31
1. In general	31
2. Detection strategies	31
3. Response strategies	32
IV. Policy and compliance issues arising from After-Tax Hedging	35
1. Introduction	35
2. Acceptable vs. unacceptable after-tax hedging: drawing the line	35
3. Challenges in detecting ATP schemes based on after-tax hedging	37
4. How to respond to ATP schemes based on after-tax hedging	38
V. Conclusions and recommendations	41
<i>Conclusions</i>	41
<i>Recommendations</i>	43

Executive summary

This report focuses on aggressive tax planning (ATP) schemes based on after-tax hedging. In general terms, after-tax hedging consists of taking opposite positions for an amount which takes into account the tax treatment of the results from those positions (gains or losses) so that, on an after-tax basis, the risk associated with one position is neutralised by the results from the opposite position. While after-tax hedging is not, of itself, aggressive - being generally a straightforward risk management technique - the report recognises that it can also be used as a feature of ATP schemes. ATP schemes based on after-tax hedging pose a threat to countries' revenue base: empirical evidence suggests that hundreds of millions of USD are at stake, with a number of multi-billion USD transactions identified by certain countries. ATP schemes based on after-tax hedging originated in the banking sector, but experience shows that they are also used in other industries and, in some instances, also by medium-sized enterprises, thus generating an even bigger threat to tax revenue. It is therefore important that governments are aware of arrangements that use hedging for ATP purposes.

The Report follows on from the 2011 OECD Report *Corporate Loss Utilisation through Aggressive Tax Planning* which recommends countries analyse the policy and compliance implications of after-tax hedges in order to evaluate the appropriate options available to address them. It was prepared by the ATP Steering Group of Working Party No. 10 on Exchange of Information and Tax Compliance of the Committee on Fiscal Affairs (CFA). The report builds on a number of country submissions to the OECD *Directory on Aggressive Tax Planning* where several ATP schemes based on after-tax hedging have been posted.

After having discussed in general terms the notion of hedging as a risk management tool and the effect of taxation on hedging transactions, the report describes the features of ATP schemes based on after-tax hedging that have been encountered by a number of countries. In those schemes, taxpayers use after-tax hedging to earn a premium return, without actually bearing the associated risks, which is in effect passed on to the government. In all of these schemes there is generally no pre-existing exposure to hedge against but rather the exposure is created as part of the relevant scheme.

ATP schemes based on after-tax hedging exploit the disparate tax treatment between the results (gain or loss) from the hedged transaction/risk on the one hand, and the results (gain or loss) from the hedging instrument on the other. In some of these schemes, the tax treatment of gains and losses arising from each transaction is symmetrical, while in others the tax treatment is asymmetrical. Other schemes rely on similar building blocks and are often structured around asymmetric swaps or other derivatives. ATP schemes based on after-tax hedging can exploit differences in tax treatment within one tax system and are in that sense mostly a domestic law issue. Any country that taxes the results of a hedging instrument differently from the results of the hedged transaction/risk is potentially exposed. The issue of after-tax hedging also arises in a cross-border context with groups of companies operating across different tax systems, which gives rise to additional challenges for tax administrations.

The report describes the strategies used to detect and respond to these ATP schemes. Detection strategies used include advance ruling applications, audits, the ordinary dialogue between the tax administration and large businesses, and mandatory disclosure rules. Response strategies have focused on denying or limiting the tax benefits for which the schemes are used by invoking the general anti-avoidance provision, by introducing specific anti-avoidance legislation or by applying the arm's length principle. In some instances a mix of strategies focusing on denying or limiting the tax benefit for which the scheme is used and on influencing taxpayer and promoter behaviour has been used.

The report describes the following main challenges raised by after-tax hedging from a compliance and policy perspective: (i) the difficulty in drawing a line between acceptable and non-acceptable after-tax hedging; (ii) the difficulties in detecting ATP schemes based on after-tax hedging, especially cross-border schemes. These difficulties arise because often there is no explicit link between the hedged item and the hedging instrument or because there is no trace of them in the taxpayers' financial statements; and (iii) deciding how to respond to ATP schemes based on after-tax hedging.

Regarding (i) the report concludes that, in practice, the decision of where to draw the line will depend on a number of elements, including the facts and circumstances of each case, the commercial reasons underlying the transactions, and the intent of the applicable domestic law. Regarding (ii) the report underlines that, in order for tax administrations to be able to face the above challenges, it is important for them to ensure they have sufficient resources and expertise to understand schemes of this nature which are often very complex. A fair and transparent dialogue with the taxpayer, as part of discussions which take place under cooperative compliance programmes, has also proven to help tax administrations gain a

better understanding. Finally, regarding (iii) the report shows that different response strategies have been used, including strategies seeking to deter taxpayers from entering into such schemes and/or promoters/advisors from promoting the use of such schemes.

Building on the work of the ATP Steering Group, the report recommends countries concerned with ATP schemes based on after-tax hedging to:

- Focus on detecting these schemes and ensure that their tax administrations have access to sufficient resources (in particular expertise in financial instruments and hedge accounting) to detect and examine in detail after-tax hedging schemes.
- Introduce rules to avoid or mitigate the disparate tax treatment of hedged items and hedging instruments.
- Verify whether their existing general or specific anti-avoidance rules are suitable to counter ATP schemes based on after-tax hedging and, if not, to consider amending those rules or introducing new rules.
- Adopt a balanced approach in their response to after-tax hedging, recognising that not all arrangements are aggressive, that hedging in and of itself is not an issue and that ATP schemes based on after-tax hedging may necessitate a combination of response strategies.
- Continue to exchange information spontaneously and share relevant intelligence on ATP schemes based on after-tax hedging, including deterrence, detection and response strategies used, and monitor their effectiveness.

I. Introduction

The past two decades have witnessed the proliferation of financial instruments available on financial markets and a constantly increasing level of sophistication in financial transactions. These developments pose difficult challenges to tax administration, not only in terms of being able to keep pace with sophisticated financial transactions but also in terms of characterising and taxing income from such transactions. These challenges were already highlighted in the OECD Reports on the *Taxation of New Financial Instruments* (1994) and on the *Taxation of Global Trading of Financial Instruments* (1998).

This report focuses on ATP schemes based on after-tax hedging. After-tax hedging essentially consists in taking opposite positions for an amount which takes into account the tax treatment of the results from those positions (gain or losses) so that, on an after-tax basis, the risk associated with one position is neutralised by the results from the opposite position. After-tax hedging is not, of itself, aggressive but is rather a straightforward risk management technique. However, it can also be used as a feature of ATP schemes. These schemes use the different tax treatment of the hedged transaction/risk and of the hedging transaction to enable taxpayers to earn a premium return without bearing the associated risk. After-tax hedging schemes can exploit differences in tax treatment within one tax system and are in that sense mostly a domestic law issue. The issue of after-tax hedging also arises, and gives rise to additional challenges for revenue authorities, in a cross-border context with groups of companies operating across different tax systems.

The OECD Report on *Attribution of Profits to Permanent Establishments* (2010) highlighted the issue of split hedges between associated enterprises¹ as a topic for future work (see page 136 of the Report). The OECD Report on *Addressing Tax Risks Involving Bank Losses* (2010) highlighted the issue in the context of international banking groups where split hedges are commonly used.² The OECD Report *Corporate Loss Utilisation through Aggressive Tax Planning* (2011) recommended countries analyse the policy and compliance implications of after-tax hedges and evaluate the options available to address them.

Following on from that recommendation, this report was prepared by the ATP Steering Group of Working Party No. 10 on Exchange of Information and Tax Compliance of the CFA. The report also builds on a number of country submissions to the OECD Directory on Aggressive Tax Planning where several ATP schemes based on after-tax hedging have been posted. If other countries have not (yet) detected such schemes, it cannot be excluded that they might be exposed to them, especially if the results of a hedging transaction are taxed differently from the results of the hedged transaction/risk.

After having described in general terms the notion of hedging as a risk management tool, the report illustrates the features of ATP schemes based on after-tax hedging, summarises the detection and response strategies that have been used by countries, highlights the compliance and policy issues arising from these schemes, and ends with a number of conclusions and recommendations.

Notes

1. The issue of split hedges refers to the situation where a company in country A holds a hedging instrument for the benefit of the group as a whole in relation to an asset or liability of an associated company in country B. As a result of a hedging strategy, losses can be recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised.
2. See Chapter 5, page 51 of the Report.

II. Aggressive Tax Planning Schemes based on After-Tax Hedging

1. In general

Risk management is a key issue in corporate management and, generally, is a relevant part of the decision making process. Depending on the case, entrepreneurs might not be willing to assume specific risks incurred in their business activities, hence, the need for hedging. In this regard, the incidence of hedging as a financial risk management tool has increased dramatically in recent years and continues to do so. In order to hedge the risks associated with interest rates, foreign currency rates, prices of commodities or of financial instruments, the use of derivatives such as futures, options and swaps has expanded tremendously. According to the Futures Industry Association, the volume of futures and option contracts traded around the world has increased from 8.86 billion USD in 2004 to 22.30 billion USD in 2010.¹

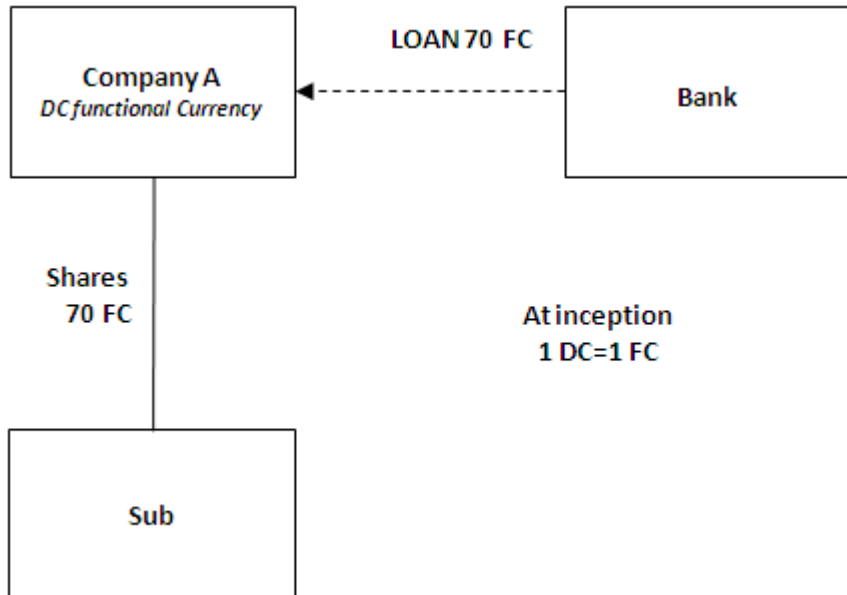
Hedging can be done in a number of ways but it essentially consists of taking equal and opposite positions so that the risk associated with one position is neutralised by the results from the opposite position. For example, a company with domestic currency (DC) as its functional currency holding foreign currency (FC) denominated shares can hedge its (long) exposure to exchange rate risk by taking an equivalent (short) position by borrowing FC for an amount equal to the value of the share investment.²

2. Hedging transactions: an example

For illustrative purposes, assume that a company purchases shares in a foreign company for an amount denominated in a foreign currency of 70 FC. Assuming that at the time of the purchase the exchange rate between the domestic currency and the foreign currency is 1 FC=1 DC, the price paid by the company for the said shares is 70 DC. As a result of the company acquiring shares in a currency different from its DC, the company is subject to a foreign exchange exposure when it sells the shares or where it accounts for the shares on an accrual basis: if the DC strengthens, the company incurs a loss on the share investment³ (e.g. exchange rate 1 FC=0.5 DC: if the

company sells the shares whose purchase price was 70 DC for 70 FC=35 DC, it incurs a loss of 35 DC). The company might then decide to hedge its foreign exchange exposure by borrowing FC, at an exchange rate of 1 DC=1 FC, for an amount equal to the value of the shares (70 FC), as shown in the diagram below.

Figure 1. FC denominated share investment



Source: OECD

The table below shows that whatever the exchange rate fluctuations, the company is not exposed to exchange rate risk: if DC strengthens, the company will derive a gain on the loan while suffering an equivalent loss on the share investment, thus effectively hedging itself; similarly, if DC weakens, the company will derive a gain on the share investment and an equivalent loss on the loan.

Table 1. Hedging Forex Exposure

F/X	Share investment	Loan	Net result
1 FC=1 DC	70 FC=70 DC	70 FC=70 DC	-
1 FC=0.5 DC	70 FC=35 DC	70 FC=35 DC	
Gain (loss)	(35 DC)	35 DC	0
1 FC=1.5 DC	70 FC=105 DC	70 FC=105 DC	
Gain (loss)	35 DC	(35 DC)	0

Source: OECD

3. The effect of the tax system on hedging transactions

A hedge is effective both before and after tax where the tax treatment of the transactions making up the hedging relationship is neutral. This means that the taxation of the results derived from the hedging transaction (in the example above, borrowing in the same currency as the one of the share investment) and that of the results derived from the hedged transaction/risk (in the example above, the acquisition/holding of shares in a currency different from the taxpayer's functional currency) mirror each other. An example of neutral tax treatment is when losses connected to one position are deductible and the gains connected to the opposite position are taxable.

Where the tax treatment of the results from the hedging transaction and that of the results from the hedged transaction/risk do not mirror each other (hereafter also referred to as "disparate treatment"), the hedge will be imperfect on an after-tax basis.⁴ Consider the following two examples⁵, where gains/losses on shares are non-taxable/non-deductible while gains/losses on loans are taxable/deductible (table 2a), or vice versa (table 2b) in that the gains/losses on shares are taxable/deductible while gains/losses on loans are non-taxable/ non-deductible.

Table 2a. Hedging Forex Exposure: imperfect hedging on an after-tax basis (assuming a 30% tax rate)

F/X	Share investment (tax rate = 0%) gains = non-taxable (losses) = non-deductible	Loan (tax rate = 30%) gains = taxable (losses) = deductible	Net Result
1 FC=1 DC	70 FC=70 DC	70 FC=70 DC	
1 FC=0.5 DC	70 FC=35 DC	70 FC=35 DC	
Pre-tax result	(35 DC)	35 DC	0
Tax benefit/(cost)	-	(10.5 DC)	(10.5 DC)
After-tax result	(35 DC)	24.5 DC	(10.5 DC)
1 FC=1.5 DC	70 FC=105 DC	70 FC=105 DC	
Pre-tax result	35 DC	(35 DC)	0
Tax benefit/(cost)	-	10.5 DC	10.5 DC
After-tax result	35 DC	(24.5 DC)	10.5 DC

Source: OECD

In the above example, if DC strengthens against FC, the company will derive gains on the loan and equivalent losses on the share investment on a pre-tax basis. However, due to the taxation of the gains on the loan, the company will be in a loss position for an amount of 10.5 DC on an after-tax basis. On the other hand, if DC weakens against FC, the company will have an after-tax gain of 10.5 DC as a result of the deduction of the losses on the loan (assuming the losses can be offset against other income) and of the non-taxation of the gain on the share investment.

Table 2b. Hedging Forex Exposure: imperfect hedging on an after-tax basis (assuming a 30% tax rate)

F/X	Share investment (tax rate = 0%) gains = taxable (losses) = deductible	Loan (tax rate = 30%) gains = non-taxable (losses) = non-deductible	Net Result
1 FC=1 DC	70 FC=70 DC	70 FC=70 DC	
1 FC=0.5 DC	70 FC=35 DC	70 FC=35 DC	
Pre-tax result	(35 DC)	35 DC	0
Tax benefit/(cost)	10.5 DC		10.5 DC
After-tax result	(24.5 DC)	35 DC	10.5 DC
1 FC=1.5 DC	70 FC=105 DC	70 FC=105 DC	
Pre-tax result	35 DC	(35 DC)	0
Tax benefit/(cost)	(10.5 DC)		(10.5 DC)
After-tax result	24.5 DC	(35 DC)	(10.5 DC)

Source: OECD

In the above example, if DC strengthens against FC, on a pre-tax basis the company can hedge its forex exposure by deriving a gain on the loan and an equivalent loss on the share investment on a pre-tax basis (or vice versa). However, on an after-tax basis the company will derive a net gain of 10.5DC due to the deduction of the losses on the share investment (assuming the losses can be offset against other income). On the other hand, if DC weakens, the company will suffer a net loss of 10.5 DC caused by the tax due on the gain on the share investment.

4. Factoring the tax treatment into the hedging transaction: over-hedging or under-hedging

It is apparent from the previous examples that in certain cases taxpayers may see an opportunity or a need to factor taxation into their hedging transactions in order to be fully hedged on an after-tax basis. Where the results from the hedging transaction are subject to a higher tax rate than the results from the hedged transaction/risk, taxpayers may take the net impact of tax on the gains or losses on the two opposite positions into account by “over-hedging”,⁶ namely by grossing up the (notional) amount of the hedging instrument using the following formula:

(notional) amount of hedging instrument (e. g. loan)	=	value of hedged item (e.g. shares)	X	$\frac{1 - \text{low tax rate}}{1 - \text{high tax rate}}$
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To illustrate this with a simplified example, if a company whose functional currency is DC makes a share investment in a subsidiary accounted for in FC, it can hedge its forex exposure on an after-tax basis by entering into a loan agreement denominated in FC for an amount that takes into account not only the value of the share investment, but also the effects of the applicable tax treatment. In the example below, assuming that the results from the share investment (i.e. the hedged item) are non-taxable/non-deductible (e.g. tax rate = 0%) and that the results from the loan (i.e. the hedging instrument) are taxable/deductible at a rate of 30%, a company with a share investment of 70 FC can fully hedge itself on an after-tax basis against the forex risk on the share investment by entering into a loan agreement for 100 FC, i.e. $70 \text{ FC} \times 1/1-0.3$ with the surplus FC spot exchanged into DC.⁷

Table 3. Over-hedging Forex Exposure: After-tax results (assuming a 30% rate)

F/X	Share investment (tax rate = 0%) gains = non-taxable (losses) = non-deductible	Loan (tax rate=30%) gains = taxable (losses) = deductible	Net Result
1 FC=1 DC	70 FC=70 DC	100 FC=100 DC	
1 FC=0.5 DC	70 FC=35 DC	100 FC=50 DC	
Pre-tax result	(35 DC)	50 DC	15 DC
Tax benefit/(cost)	0	(15 DC)	(15 DC)
After-tax result	(35 DC)	35 DC	0
1 FC=1.5 DC	70 FC=105 DC	100 FC=150 DC	
Pre-tax result	35 DC	(50 DC)	(15 DC)
Tax benefit/(cost)	0	15 DC	15 DC
After-tax result	35 DC	(35 DC)	0

Source: OECD

In the above example, if DC strengthens against FC, the company derives a gain on the loan equal to 50 DC and a loss on the share investment equal to 35 DC on a pre-tax basis. However, the loss on the share investment is non-deductible for tax purposes while the gain on the loan is subject to a

tax equal to 15 DC. As a consequence, the company will be fully hedged on an after-tax basis, with the government receiving an additional tax of 15 DC in this case paid for by the taxpayer through the surplus FC spot exchanged into DC. On the other hand, if DC weakens against FC, the company derives a gain on the share investment equal to 35 DC and a loss on the loan equal to 50 DC on a pre-tax basis. The gain on the share investment is non-taxable while the loss on the loan is deductible for tax purposes thus triggering a tax benefit equal to 15 DC (assuming the losses can be offset against other income). As a consequence, the company will be fully hedged on an after-tax basis, with the government suffering a reduction in tax revenue equal to 15 DC in this case, which offsets the loss incurred on the FC amount spot exchanged into DC.

5. ATP schemes based on after-tax hedging

a. In general

Even though over-hedging may in some cases be a realistic solution for taxpayers wishing to fully hedge themselves on an after-tax basis, a number of cases were detected where differences in the tax treatment applicable to gains or losses on the hedged transaction/risk as compared to the tax treatment applicable to the hedging transaction have been promoted to and exploited by certain taxpayers. Whether after-tax hedging should be accepted as a natural consequence of the disparate treatment of certain items or should rather be considered as aggressive and challenged will depend on a number of elements, including the facts and circumstances of each case, the commercial reasons underlying the transactions, and the intent of the applicable domestic law.

Several countries have encountered ATP schemes where taxpayers use after-tax hedging to make higher returns, without actually bearing the associated risks. In general, in all of these schemes, there is no pre-existing exposure to hedge against but rather the exposure is created as part of the relevant scheme. These schemes exploit the disparate tax treatment between the results (gain or loss) on the hedged transaction/risk on the one hand, and the results (gain or loss) on the hedging instrument on the other. It should be noted that in some of these schemes the tax treatment of gains and losses arising on each transaction (i.e. the hedging and the hedged transaction/risk) is symmetrical, while in others the tax treatment is asymmetrical. Other schemes rely on similar building blocks and are often structured around asymmetric swaps or other derivatives. Examples of the schemes are described on pages 18-25 below.

b. ATP schemes where the tax treatment of the results from the hedging instrument is symmetrical

Examples of ATP schemes where the tax treatment of the results from the hedging instrument is symmetrical have been encountered by a number of countries. In these schemes, after-tax hedging was used to enter into riskless carry trades.⁸ The artificial nature of these schemes was mainly related to the fact that the share investment was not the purpose of the arrangement but merely a means to obtain a tax advantage. Their common elements were: a) borrowing in a FC and investing a percentage in the same currency, b) spot exchanging the balance of the amount borrowed into the DC where interest rates are comparatively high, c) the percentages invested and spot exchanged are determined by the tax rate and d) the total amount borrowed is subject to tax on movements in the exchange rate as opposed to the amount invested that is not.

In other words, the amount of the FC debt is calculated by grossing up the amount of the manufactured share investment by the tax rate. The FC excess amount borrowed, once spot exchanged in DC, enables the taxpayer to enter into riskless carry trades. Except in extreme cases (e.g. in the cases of severe movements in exchange rates), whatever the movements in the exchange rates, the taxpayer is economically indifferent to the foreign exchange risk which, in turn, is borne by the government. As the taxpayer has an economic hedge, it can enjoy profits on the differences in interest rates not available to market participants who have had to purchase forward cover.

c. ATP schemes where the tax treatment of the results from the hedging instrument is asymmetrical

Other schemes encountered by countries not only rely on the disparate tax treatment of the results from the hedged transaction/risk as compared to the results from the hedging instruments, but also on the fact that the tax treatment of the results on the hedging instrument is asymmetrical (i.e. gains on the hedging instrument are not taxed while losses are deductible). This is summarised in the table below.

Table 4. After-tax hedging with asymmetrical tax treatment of results from hedging instrument

		Hedged transaction/risk	Hedging instruments		
		(disparate tax treatment)			
symmetrical tax treatment ↑ ↓		Gains= non taxable	Loss= deductible	asymmetrical tax treatment ↑ ↓	
		Loss= non deductible	Gains= non taxable		

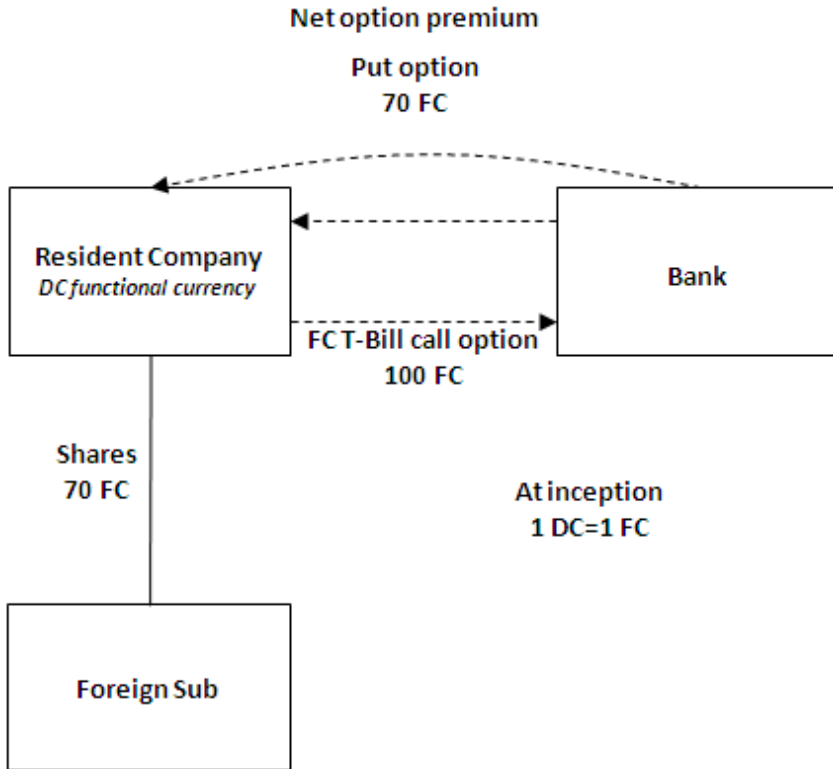
Source: OECD

Accordingly, on an after-tax basis, tax benefits are obtained in the case of gains on the hedged item, which are not taxed, and losses on the hedging instrument, which are deductible. On the other hand, there are no tax consequences in the case of losses on the hedged item, which are non-deductible, and gains on the hedging instrument, which are not taxed. In these cases, the tax liability of the group either falls or remains constant, depending on the movement of the underlying rate or index, while the hedge is maintained after tax.

This type of scheme may, for example, use option arrangements having a “one-way exchange effect” (i.e. with forex losses being deductible and forex gains not being taxed). The relevant scheme involves a resident company which accounts in DC and holds shares in a foreign subsidiary accounted for in FC. The structure exploits the disparity in the way the tax system treats FC options (i.e. forex gains on such options are not taxable) compared with how it treats options over FC denominated Treasury Bills (i.e. forex losses on such options are deductible). To hedge its forex exposure in respect of the shares, the resident company grants a call option⁹ to a third party over FC denominated Treasury Bills in an amount equal to the value of the shares grossed up to reflect the applicable corporate tax rate. It also acquires a put option¹⁰ over FC in an amount equal to the value of the shares. In consideration for the options, the resident company receives a premium under the call option and pays a premium under the put option. As the nominal value of the underlying of the call option (i.e. the FC denominated Treasury Bills) is greater than that under the put option (i.e. the FC), the resident company

receives net premium income. A diagrammatical representation of the scheme is presented in Figure 2.

Figure 2. Option arrangements with a one-way exchange effect



Source: OECD

Depending on the exchange rate movements, either the resident company or the third party exercises the relevant option and the other option is allowed to lapse unexercised. On an after-tax basis, if the FC weakens against the DC, the loss on the shares will offset the untaxed gain on the put option. If, by contrast, the FC strengthens against the DC, the gain on the shares will offset the deductible loss on the call option. The following example illustrates these results, assuming a corporate tax rate of 30%:

Table 5. Over-hedging Forex Exposure through Options with One-way Exchange Effect: After-tax results

F/X	Share investment (tax rate = 0%) gains = non taxable (losses) = non deductible	Sells Call option on FC T-Bills (tax rate = 30%) (losses) = deductible	Buys Put option on FC (tax rate = 0%) gains = non taxable	Net Result
1 FC=1 DC	70 FC=70 DC	100 FC=100 DC	70 FC=70 DC	
1FC=0.5DC	70 FC=35 DC	100 FC=50 DC	70 FC=35 DC	
Pre-tax result	(35 DC)	-	35 DC	0
Tax benefit/(cost)	-	-	-	-
After-tax result	(35 DC)		35 DC	0
1 FC=1.5 DC	70 FC=105 DC	100 FC=150 DC	70 FC=105 DC	
Pre-tax result	35 DC	(50 DC)	-	(15 DC)
Tax benefit/(cost)	-	15 DC	-	15 DC
After-tax result	35DC	(35 DC)	-	0

Source: OECD

In the above example, if DC strengthens against FC, the resident company derives a loss on the share investment equal to 35 DC. At the same time, the resident company will exercise its “in-the-money” put option on FC, deriving a gain equal to 35 DC. The call option on FC denominated Treasury Bills is “out-of-the-money” and is therefore left unexercised. Accordingly, after-tax the resident company is fully hedged and there is no impact on tax revenues.

On the other hand, if DC weakens against FC, the resident company derives a gain on the share investment equal to 35 DC. At the same time, the third party will exercise its “in-the-money” call option on FC denominated Treasury Bills with the resident company bearing a deductible loss of 50 DC. The put option on FC is “out-of-the-money” and is therefore left unexercised. Since the loss on the FC denominated Treasury Bills is deductible for tax purposes, the resident company receives a tax benefit equal to 15 DC. Accordingly, after tax the resident company is fully hedged with the government receiving a reduction in tax revenue equal to 15 DC in this case.

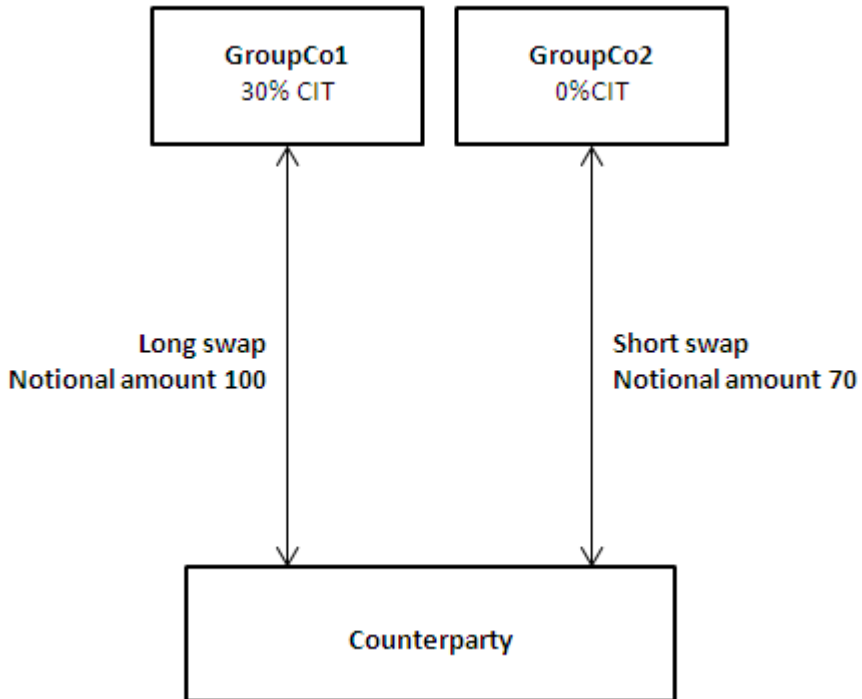
In other words, the tax liability of the resident company either falls (where the FC strengthens) or remains constant (where the FC weakens),

while the hedge against forex exposure is maintained after tax. As in the case of the carry trade schemes, the taxpayer is economically neutral but is able to derive additional income. In the current case this is the net premium income derived from the option agreements.

d. ATP schemes involving asymmetric swaps or other derivatives with an embedded after-tax hedge

Some countries have also encountered schemes which rely on similar building blocks and are often structured around swaps¹¹ or other derivatives.¹² These schemes generally involve an unrelated non-resident counterparty entering into a long swap over a benchmark index with a group company subject to a normal corporate tax rate (GroupCo1) and into a short swap over the same benchmark index with another group company subject to a lower tax rate (GroupCo2).

The short and long swaps mirror each other but for the notional amounts which is why they are often referred to as “asymmetric swaps”. The notional amounts are calculated by reference to the different tax rates applicable to the two group companies, using the formula described on page 16. In other words, the notional amount of the long swap is determined by grossing up the notional amount of the short swap by the tax rate differential of GroupCo1 compared to GroupCo2. Figure 3 presents a simplified diagram of the basic scheme.

Figure 3. Asymmetric swaps with an embedded after-tax hedge

Source: OECD

In addition to the formula used to determine the notional amounts of the swaps, asymmetric swap schemes often present other distinctive features, namely: a drift adjustment, a leverage factor and fee payments. The drift adjustment percentage is imposed at the start of the swap term and is commonly based upon the historical performance of the benchmark index so as to purportedly have the effect of making the index's performance neutral over time.¹³ The leverage factor increases the effect of movements in the underlying benchmark index on the payments made under the swaps. The fee payment for the risk premium made by the counterparty to the taxpayer takes into account the exposure on both the long and the short swap.

Under the swap agreements there is no initial exchange of the principal amounts of the swaps, although the Counterparty may provide a cash collateral deposit as security for its maximum net exposure under the swaps. The Counterparty makes periodic fee payments over the term of both the short and the long swap. At the conclusion of the asymmetric swap scheme, a single net payment is made between the Group (that is, GroupCo1 and

GroupCo2 together) and the Counterparty, based upon the movement of the index after application of the drift adjustment to the long and short swaps.

The effect of this scheme is that on a pre-tax basis the Group has a net long exposure, whereas the Counterparty will have an identical net short exposure. On an after tax basis, however, the Group will have no exposure as the risk and exposure of the hedge is effectively passed to the tax administration. This is achieved through:

- **The index movement:** On a pre-tax basis the Group may make profits or losses depending on the benchmark index fluctuations. On an after-tax basis, however, it does not make any profit or loss. This occurs because the structure establishes an effective tax rate of 100% (in other words the after-tax profits are equal to zero) in relation to the asymmetric swaps.
- **The drift adjustment:** Although the drift is referred to as an 'adjustment' purported to remove a directional bias in the index, economically it is a payment obligation being a fixed and determined amount taken on by the relevant party at the start of the swaps and adjusted over the term of the swaps and included in the calculation of the final net payment upon termination of the swaps. On a net basis, the drift adjustment represents a payment by the Group to the Counterparty. The Group pays the net drift over the term of the swaps and because of the design features of the scheme it is fully compensated for this payment by the tax outcome.
- **The fees:** The Counterparty makes a payment on both the long swap and the short swap. In a commercial swap transaction it would be expected that if a fee was paid in one direction on the long swap by one party, then a fee would be paid in the opposite direction by the other party on the short swap. The stated reason for the Counterparty being willing to make a payment on both of the swaps is that it is seeking to hedge a long exposure it has in its proprietary trading business. To obtain the hedge, the Counterparty is prepared to make a payment on both of the swaps to obtain the net short position from the combination of the two asymmetric swaps. The payment is calculated as the aggregate of a negotiated percentage of the notional amounts of the long swap and short swap.

Table 6 illustrates in simplified terms the tax results of these schemes but without taking into account the drift adjustments or the fees (assuming that taxpayer A1 is subject to a 30% tax rate, while taxpayer A2 is subject to a 0% tax rate):

Table 6. Asymmetric Swaps: After-tax results

Benchmark Index	Long Swap (A1)	Short Swap (A2)	Net Result
Basket of shares	Notional:100	Notional: 70	Long Exposure: 30
Index movement : +100%			
Pre-tax result	100	(70)	30
Tax benefit (cost)	(30)	-	(30)
After-tax result	70	(70)	0
Index movement : -100%			
Pre-tax result	(100)	70	(30)
Tax benefit (cost)	30	-	30
After-tax result	(70)	70	0

Source: OECD

As the table above shows, regardless of the movement of the benchmarking index, the taxpayer is hedged on an after-tax basis and is effectively providing a hedge to the Counterparty for a short exposure equal to 30. The risk due to the movements in the index is effectively passed to the government of State A (if A1 and A2 are residents of that State) or State A1 (if A1 and A2 are residents of different States). In one case, the tax revenue of State A or State A1, as the case may be, increases, while in the other case it reduces. The consolidated effect of the scheme is therefore neutral from an after-tax perspective, with an enhanced return derived by the Group as a result of the Counterparty paying a fee/risk premium on both the long swap and the short swap.

Examples of these schemes have been encountered by several countries. These schemes may, for example, exploit differences in tax rates applicable in the same country or different tax rates applicable to group companies across different jurisdictions. In other words, these schemes rely on differences in tax rates to allow the taxpayer to obtain income (in the form of the fees received from the counterparty) without incurring any risk on an after-tax basis. Other schemes present certain differences but show the same features in terms of (i) over-hedging a previously non-existing exposure, (ii) a drift adjustment, (iii) a leverage factor and (iv) fee payments/enhanced dividends. The main differences when compared to the asymmetric swaps are that the two legs of the transaction are constituted by an investment in preference shares whose value is linked to a benchmark index, with the benchmark index also being the object of a forward purchase agreement¹⁴ with an over-hedge. The zero-tax rate is achieved instead through the use of existing capital losses which are used to offset the tax liability of any capital gains made under the scheme.

Notes

1. See www.futuresindustry.org/downloads/FIAAnnounces2010Volume.pdf.
2. In finance, a long position in a security, such as a stock or a bond means that the holder of the position will derive gains if the underlying asset rises in value. On the contrary, a short position means that the holder of the position will derive gains if the underlying asset falls in value.
3. For simplification purposes, in all the examples changes in the value of the shares due to gains or losses (either realised or unrealised) are not considered.
4. Inconsistencies in tax treatment may also derive from the fact that the hedged transaction/risk is taxed on an accrual basis, while the hedging instrument is taxed on a realisation basis (or vice-versa). Generally, in these cases, the tax effects are temporary, although taxpayers might find ways to convert temporary inconsistencies into permanent ones.
5. For simplification purposes, in the examples, changes in the value of the shares due to gains or losses (either realised or unrealised) are not considered.
6. Where the results from the hedging transaction are subject to a lower tax rate than the results from the hedged transaction/risk, the net impact of tax on the gains or losses on the two opposite positions may be taken into account by “under-hedging”, namely by reducing the (notional) amount of the hedging instrument using the following formula:

notional amount of hedging instrument (e. g. loan)	=	value of hedged item (e.g. shares)	X	$\frac{(1 - \text{high tax rate})}{(1 - \text{low tax rate})}$
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7. In order for the after-tax hedge to be effective, the 30 FC surplus needs to be spot exchanged into DC (1 DC= 1 FC) or hedged through other means. Otherwise, a forex exposure on this amount would still remain, leading to similar economic results as in the cases of imperfect hedging (table 2a or table 2b).
8. A “carry trade” involves an investor borrowing in a currency with low interest rates and investing in a currency with high interest rates. A conventional carry trade runs the risk that the interest rate differential enjoyed between the two currency pairs will be offset by negative

movements in the exchange rate between those two currencies. Therefore for carry trades to be profitable, it is essential to invest in currencies whose exchange rates are expected to be stable over time.

9. A call option is a contract between two parties which gives the buyer of the call option the right (but not the obligation) to buy a specified underlying asset (“the underlying”) from the seller of the call option on or before a particular date at a specified price. The seller of the call option has the obligation to sell the underlying at the specified price if the buyer exercises the option. The buyer of the call option pays a fee (called premium) for this.
10. A put option is a contract between two parties which gives the buyer of the put option the right (but not the obligation) to sell the underlying to the seller of the put option on or before a particular date at a specified price. The seller of the put option has the obligation to buy the underlying at the specified price if the buyer exercises the option. The buyer of the put option pays a premium for this.
11. A swap is an agreement between two parties to exchange payments over a specific period. The prices, values or levels of the asset(s) or indices underlying the swap determine the payments. The party taking a long position under a swap (referred to as a “long swap” from the perspective of that party) will profit if the underlying rises in value. The party taking a short position under a swap (referred to as a “short swap” from the perspective of that party) will profit if the underlying falls in value.
12. A derivative is an instrument whose value is dependent on, or derived from, the value of some underlying asset (typically a commodity, bond, equity or currency). Examples include: forwards, futures, options and swaps.
13. The purported neutrality of the drift adjustment is artificial, basically, because it would imply that the value at inception of the positions taken by each participant (on a stand-alone basis) should have been determined or evaluated on the basis of a theoretical approach not acceptable or shared in the financial market at arm’s length and commonly referred to as the “non arbitrage theory”.
14. A forward purchase agreement is an agreement between two parties to buy or sell an asset at an agreed price for delivery on a specified future date.

III. Strategies used to detect and respond to ATP Schemes based on After-Tax Hedging

1. In general

This section is based on the experience of countries that have detected and tackled ATP schemes based on after-tax hedging described in section II. These schemes came to the attention of the different tax administrations through a variety of means, including mandatory disclosure rules, advance ruling requests, audits, and the ordinary dialogue between the tax administration and large businesses. These detection strategies are described in more detail below. In terms of responses, the strategies used have essentially focused on denying or limiting the tax benefits sought by the schemes, sometimes in combination with strategies focusing on influencing taxpayer's and promoter's behaviour. The response strategies used by such countries are described in more detail below.

2. Detection strategies

Detection strategies can be divided into five main categories: (i) strategies, whether designed as detection tools or not, that cause taxpayers or third parties to provide relevant information to the tax administrations (disclosure and reporting), (ii) strategies where the tax administration is not in the role of a “passive” recipient of information but is in an active role seeking to detect relevant information by using its investigative powers (investigations and audits), (iii) strategies that seek to build on information held either by other government departments or that involve co-operation with the tax administration of another country (domestic and international co-operation), (iv) strategies that seek to make the best use of internal tax administration information or external public data (data analysis), and (v) strategies not covered otherwise (other detection strategies).

As regards ATP schemes based on after-tax hedging, strategies used to detect these schemes included:

- ***Mandatory disclosure rules:*** these rules serve a similar purpose, namely to provide the tax administration with early information on certain ATP schemes and their users and thereby allow for a faster and more effective response. Where applicable, they have proven useful in detecting ATP schemes based on after-tax hedging and subsequent variations of the same.

- **Advance ruling requests:** although ruling mechanisms are not primarily designed to detect ATP schemes, they can nevertheless generate relevant intelligence on them. For example, in several instances the tax administration was able to detect the type of arrangements described in this report as a result of ruling applications from taxpayers regarding the tax treatment of these types of arrangements.
- **Audits:** several countries detected these schemes through an analysis of the taxpayer's financial statements that showed relevant losses connected with financial operations. Based on this first evidence, and subsequent audits, the tax administration was able to detect ATP schemes based on after-tax hedging.
- **Ordinary dialogue with large businesses:** co-operative compliance programs encourage responsible tax reporting and discourage aggressive tax planning on the part of taxpayers. Countries that have engaged in such initiatives generally do so as one important component of a wider compliance strategy which encompasses a balance between guiding and supporting risk management by taxpayers, alongside audit and other enforcement actions. For example, an ATP scheme based on after-tax hedging came to the attention of the relevant tax administration when the taxpayer approached it about a proposed extension of the arrangement, approximately one year after it was first executed but before the taxpayer was required to take a tax position in respect of the transaction.

These strategies have often been used in combination with other strategies focusing on internally disseminating knowledge and information regarding these schemes. A number of countries have dealt with these schemes in seminars for field staff to alert them of the salient features. In other countries, after the relevant audit was finalised, the case was included in the tax authorities' standardised risk-analysis database for large business taxpayers and a general audit plan was prepared to be shared with local offices for tackling similar cases. Finally, in several cases, details of one of these types of transactions have been shared with the relevant treaty partners.

3. Response strategies

Strategies used to respond to these schemes essentially focused on denying or limiting the tax benefits sought by the schemes, sometimes in combination with strategies focusing on influencing taxpayer and promoter behaviour. The following provisions were used:

- **General anti-avoidance rules (GAAR):** the relevant GAAR was applied to cancel any tax benefit under the arrangement which would otherwise be allowable. This is the case where the relevant scheme presents a number of unusual features which suggest that it had not been entered into for commercial business reasons but to unduly obtain tax benefits.
- **Specific anti-avoidance rules:** specific anti-avoidance rules have proven to be an effective tool to respond to ATP schemes. One country introduced specific anti-avoidance legislation to deal with these schemes. The relevant legislation was a response to a particular transaction but after some time it was apparent that some taxpayers were using a range of structures to achieve the same economic effect and that a broader approach was necessary to counteract them. The relevant legislation was therefore replaced with broader anti-avoidance rules.
- **Transfer pricing:** There are a number of features of these arrangements that suggest that the pricing does not conform to accepted commercial methodologies and practices. The tax authorities have therefore raised a transfer pricing or profit reallocation adjustment with respect to transactions forming part of the arrangement. For example, in the case of asymmetric swap arrangements, transfer pricing-based responses were chosen due to the fact that the schemes entailed deliberate mispricing of the derivatives.

Some countries have used these strategies in combination with others focusing on influencing taxpayers and promoters' behaviour. These strategies included setting out the tax administration's technical position on the arrangement by issuing a draft tax ruling for public comment. In addition, discussions with the various participants in the arrangements (promoters, advisors and taxpayers) were held and additional reporting requirements were also introduced.

These strategies were particularly useful considering the difficulties in detecting these schemes. In fact, they triggered a marked change in taxpayers' behaviour. The proliferation of the arrangement ceased. In certain jurisdictions where tax administrations have a ruling system, prospective participants withdrew their ruling requests and/or warranted not to execute the arrangement. Furthermore, the entities involved in developing and promoting the arrangement have ceased marketing and implementing the arrangement.

IV. Policy and compliance issues arising from After-Tax Hedging

1. Introduction

After-tax hedging raises a number of challenges from a compliance and a policy perspective. These challenges relate chiefly to (i) the difficulty in drawing the line between arrangements that should be accepted and those that should be countered, (ii) the challenges in detecting these schemes, and (iii) the existence of appropriate domestic law measures to counter schemes that are considered to be aggressive.

In order to be able to face those challenges, it is necessary for tax administrations to have a good understanding of the financial world and hedging generally as well as large corporates' hedging policies. It is therefore important for tax administrations to ensure they have staff with the relevant background and expertise to understand schemes of this nature which are often very complex. A dialogue with the taxpayer, as part of discussions which take place under co-operative compliance programs, is also important to help tax administrations gain a better understanding.

2. Acceptable vs. unacceptable after-tax hedging: drawing the line

After-tax hedging can be on a sliding scale from acceptable to objectionable depending on the degree of commerciality/artificiality of the transactions at stake and the extent to which risk is actually borne by the taxpayer. Although taxpayers may have a wide range of instruments to fully hedge on an after-tax basis, it is also possible that over/under hedging is the only realistic option. For example, this is the case when the tax system itself does not allow the taxpayer in a genuine transaction to avoid the disparate tax treatment of the results from the hedged item as compared to the results from the hedging instrument. On the other hand, the ATP schemes illustrated in this report and encountered by a number of countries present a number of artificial features, which effectively allow taxpayers to earn a premium return without bearing the associated risks. The premium return in these cases occurred in the following manner:

- In the case of the ATP schemes where the tax treatment of the hedging instrument is symmetrical: the ability to enter into riskless carry trades enabling the taxpayer to enjoy profits on differences in interest rates not available to market participants who would have to purchase forward cover;
- In the case of the ATP scheme where the tax treatment of the hedging instrument is asymmetrical: the receipt of net premium income as a result of the taxpayer receiving a premium under the call option and paying a premium under the put option where the nominal value of the underlying of the call option was greater than that under the put option; and
- In the case of the ATP schemes involving asymmetric swaps with an embedded after-tax hedge: the receipt of fee payments/risk premia on both the long and the short swaps, sometimes in combination with the deliberate mispricing of those premia to shift income, or the receipt of fee (or premium) payments in the form of a discount embedded in the forward purchase agreement and enhanced dividend payments on the preference shares.

From a tax administration perspective, it is interesting to compare the tax consequences of hedging at the same value as that of the hedged item (see the example in table 2a) with the tax consequences of after-tax hedging as shown in tables 3 and 5:

Table 7. Comparing tax consequences of hedging

	Hedging at same value (Base case)	Over-hedging – symmetric treatment (Table 3)	Over-hedging – asymmetric treatment (Table 5)
Domestic Currency strengthens (1 FC=0.5 DC)	Tax benefit/(cost): (10.5 DC)	Tax benefit/(cost): (15 DC)	Tax benefit/(cost): 0
	After-tax result: (10.5 DC)	After-tax result: 0	After-tax result: 0
Domestic Currency weakens (1 FC=1.5 DC)	Tax benefit/(cost): 10.5 DC	Tax benefit/(cost): 15 DC	Tax benefit/(cost): 15 DC
	After-tax result: 10.5 DC	After-tax result: 0	After-tax result: 0

Source: OECD

In cases where the tax treatment of the hedging instrument is symmetrical, depending on the movement of the currencies involved, the taxpayer will pay more or less in taxes than in the case where the value of the hedging instrument would have the same value as that of the hedged

transaction. On the other hand, where the tax treatment of the hedging instrument is asymmetrical, regardless of the movement of the currencies involved, the taxpayer will always pay less tax than in the base case. In other words, arrangements where the tax treatment of the hedging instrument is symmetrical do not always lead to better tax consequences for the taxpayer, which may, depending on the currency exchange rate fluctuations, pay more tax than if the hedging instrument had the same value as that of the hedged transaction. This could therefore make it difficult to consider that such arrangements are of an aggressive nature, unless the overall arrangements present artificial features and are entered into for the main purpose of allowing taxpayers to earn a premium return, while the associated risks are passed to the government through the tax charge. This was the case for all of the after-tax hedging schemes illustrated in this report.

In practice, whether after-tax hedging should be accepted as a natural consequence of the disparate treatment of certain items or should rather be considered as aggressive and challenged will depend on a number of elements, including the facts and circumstances of each case, the commercial reasons underlying the transactions, and the intent of the applicable domestic law. For example, in some cases it was noticed that initial instances used existing FC share capital but later instances have seen companies acquiring the necessary shares simply to allow them to undertake the schemes. In these cases it is difficult to see the economic and commercial reasons to hedge exposures on arrangements that have been created merely to take advantage of the hedging itself. Similarly, in other cases taxpayers created a forex exposure in order to put after-tax hedging schemes in place as part of a strategy to earn a premium return without bearing associated risks. In one example, the group effectively borrowed 100 FC1 at low interest rates and used it to earn interest on 100 FC2 at high interest rates. Through after-tax hedging, the taxpayer had no economic exposure in either currency.

3. Challenges in detecting ATP schemes based on after-tax hedging

The use of after-tax hedging schemes became particularly apparent as a consequence of the global financial crisis and the effect it had on currency exchange rates. For example, as a result of the decline in the exchange rates of its DC against certain FC, companies using after-tax hedging schemes claimed large tax repayments in respect of forex losses and this triggered enquiries from the tax authorities. After-tax hedging schemes, and in particular cross-border ones, are hard to detect. It is therefore likely that their true impact on the tax base is often not entirely known to many tax administrations. These schemes can also be difficult to identify in an audit or pre-audit context as there might not be an explicit link between the

hedged item and the hedging instrument, particularly when the hedged item is in one company, while the hedging is executed by a related party or is broken up further across several related parties and/or related parties in other jurisdictions. Further, when transactions are executed within the course of a taxable period there may be no immediate traces of them in the taxpayer's financial statements thus making it more difficult to detect in an audit phase.

In order to be able to detect ATP schemes based on after-tax hedging, it is important that revenue officials have a first-rate understanding of finance and hedging. It is fundamental for tax administrations to ensure they have staff with the relevant background and expertise to understand the rationale and the key industry drivers and therefore be able to detect these very complex and engineered ATP schemes. An appropriate understanding of finance and hedging is pivotal to perform targeted selections or to identify clusters of taxpayers potentially using ATP schemes based on after-tax hedging. In addition to providing training to existing staff, it may be necessary for tax administrations to recruit staff with relevant industry experience externally. Tax administrations that have adopted this approach have experienced exceptional results.

It is also important for revenue officials to engage in a fair and transparent dialogue with the taxpayer in order to gain a better understanding of the taxpayer's business and hedging policies. This is often done as part of discussions taking place under co-operative compliance programmes. Countries that have adopted this approach have reported that taxpayers have refrained from entering into certain ATP schemes. Furthermore, thanks to this dialogue, early intelligence on the schemes, and additionally on their promoters, has been gathered in an effective way.

Many countries have launched projects to examine the extent of the dissemination of these schemes in their countries and are considering different methods to make enquiries regarding these schemes.

4. How to respond to ATP schemes based on after-tax hedging

This report shows that different response strategies can be used to tackle ATP schemes based on after-tax hedging. As previously outlined, these strategies include GAARs, specific anti-avoidance rules and transfer pricing adjustments based on the arm's length principle. The application of GAARs features prominently among the different response strategies used or under consideration. These rules may be applied with a reasonable level of comfort to arrangements that lack commercial reasons and/or exhibit artificial and contrived features. Transfer pricing rules have also been used, in particular to respond to asymmetric swaps with an embedded after-tax hedge. Some of

these schemes may also be challenged under specific anti-avoidance rules which deny deductions arising from transactions where the company had a main purpose of obtaining a tax advantage. Whether legislative changes are needed to effectively tackle these schemes is a question to be answered on a country-by-country basis.

Deterring taxpayers from entering into ATP schemes based on after-tax hedging and/or promoters/advisors from promoting the use of such schemes is also part of countries' strategies. Such deterrence strategies include: (a) educating taxpayers through the issuance of public rulings or tax determinations setting out the tax administrations' views about the tax consequences of a particular scheme; (b) applying promoter penalties; or (c) imposing additional reporting obligations.

Finally, it is worth mentioning, that a fair policy on the taxation of hedging transactions should generally be driven by the need to ensure that as far as possible legitimate commercial hedging transactions can be carried out on a tax neutral basis. For a hedge to be effective both before and after tax, the tax treatment of these transactions should be neutral, i.e. the taxation of the results derived from the hedging transaction and those derived from the hedged transaction/risk should be symmetrical, in that losses connected to one position should be deductible if the gains are taxable on the opposite position and vice versa. When this is not the case, there may in fact be situations where taxpayers seek to undertake entirely commercial hedging transactions where over-hedging or under-hedging is the only realistic way of providing an effective after-tax hedge.

V. Conclusions and recommendations

Countries' strategies have to operate within the broader context of a country's tax system, administrative practice and culture. It is up to each country to decide how to approach the issues addressed in this report and what responses would be the most appropriate in the context of, and the most consistent with, its rules and framework. It is against this background that this report reaches the following conclusions and recommendations.

Conclusions

- ATP schemes based on after-tax hedging pose a threat to tax revenue. Any country that taxes the results of a hedging instrument differently from the results of the hedged transaction/risk is potentially exposed to such schemes.
- ATP schemes based on after-tax hedging originated in the banking sector, but there is evidence that they are also used in other industries and, in some instances, also by medium-sized enterprises, thus generating an even bigger threat to tax revenue.
- It is important that governments are aware of arrangements that use hedging for ATP purposes. ATP schemes based on after-tax hedging pose a number of challenges, in particular regarding the difficulties in detecting such schemes and in deciding whether and how to respond to them.
- Engaging in a dialogue with the taxpayer through co-operative compliance programmes, having staff with the relevant background and expertise to understand the rationale and the key industry drivers and therefore be able to detect these very complex and engineered ATP schemes have proven extremely helpful. In addition to providing the necessary training to existing staff, it may be necessary for tax administrations to recruit staff with relevant industry experience externally.

- Not all after-tax hedging arrangements are aggressive. It is therefore important for governments to exercise considerable care when designing and applying deterrence, detection and response strategies.
- Exchanges of information, spontaneously and on request, and the sharing of intelligence on ATP schemes based on after-tax hedging, their deterrence, detection and response strategies have proven to be extremely useful.

Recommendations

Based on these conclusions, and building on the work of the ATP Steering Group, this Report recommends countries concerned with ATP based on after-tax hedging to:

- Focus on detecting these schemes and ensure that their tax administrations have access to sufficient resources (in particular expertise in financial instruments and hedge accounting) to detect and examine in detail after-tax hedging schemes.
- Introduce rules to avoid or mitigate the disparate tax treatment of hedged items and hedging instruments.
- Verify whether their existing general or specific anti-avoidance rules are suitable to counter ATP schemes based on after-tax hedging and, if not, to consider amending those rules or introducing new rules.
- Adopt a balanced approach in their response to after-tax hedging, recognising that not all arrangements are aggressive, that hedging in and of itself is not an issue and that ATP schemes based on after-tax hedging may necessitate a combination of response strategies.
- Continue to exchange information spontaneously and share relevant intelligence on ATP schemes based on after-tax hedging, including deterrence, detection and response strategies used, and monitor their effectiveness.

Aggressive Tax Planning based on After-Tax Hedging

Aggressive tax planning (ATP) schemes based on after-tax hedging pose a threat to countries' revenue base: empirical evidence suggests that hundreds of millions of USD are at stake, with a number of multi-billion USD transactions identified by certain countries. After having described in general terms the notion of hedging as a risk management tool and the effect of taxation on hedging transactions, this report illustrates the features of ATP schemes based on after-tax hedging, summarises the detection and response strategies that have been used by countries, highlights the compliance and policy issues arising from these schemes, and ends with a number of conclusions and recommendations.

Table of contents:

- I. Introduction
- II. Aggressive Tax Planning Schemes based on After-Tax Hedging
- III. Strategies used to detect and respond to ATP Schemes based on After-Tax Hedging
- IV. Policy and Compliance issues arising from After-Tax Hedging
- V. Conclusions and recommendations