

Tax Treatment of Financial Derivatives

Introduction

1. HMRC has been asked to clarify the tax treatment of financial derivative transactions, in the light of commercial developments in this area and the increasing significance of such transactions, particularly within the Financial Services Sector.
2. Although this issue has been raised with us by the asset management industry the concepts considered in paragraphs 6 to 8 below constitute generic guidance, applying to financial derivatives in whatever context they are used. This guidance will be incorporated into the relevant section of HMRC's Business Income Manual ('BIM') in due course.
3. However for the avoidance of doubt it should be stressed that this guidance on the particular characteristics of financial derivative transactions does not in any way alter the HMRC view of the distinction between trading and investment in the wider context of a commercial activity (or activities) as a whole. General advice on the distinction between trading and investment can be found at in at BIM20000 onwards.

Background

4. The characteristics of certain financial derivative transactions appear to have created uncertainty as to how those transactions should be taxed. Discussions between HMRC, the IMA and asset management industry representatives have identified certain principles relevant to the taxation of such transactions. These are described below.
5. In this context it should be noted that Tax Bulletin 80 intended to make clear that the tax treatment of gains and losses on derivative financial instruments will follow their characterisation in accordance with the principles laid down in the IMA SORP.

Concepts

6. Financial transactions include the acquisition, holding, dealing with and disposal of financial assets such as shares and bonds, but also include taking synthetic positions in relation to such assets or corresponding indices, or discrete components of them.
7. In HMRC's view, there is no conceptual difference between a 'real' and a synthetic financial transaction (for example, buying a share or entering into a derivative contract that replicates the risks and rewards of ownership). We also accept the following propositions:
 - a) Short positions are conceptually the same as long positions.

Buying a share because you take the view that its price will rise and shorting a share because you think its price will fall are conceptually the same. In simple

terms, a view is merely being taken on the direction of movement. It follows that synthetic long and short positions are conceptually the same as one another and the equivalent real transactions.

- b) Derivatives that give exposure to part of an asset are conceptually the same as derivatives that give exposure to the whole asset.

A view may be expressed on a bundle of components embedded in an instrument, for example the coupon, liquidity, credit risk and currency of a bond, or alternatively a view may be expressed on one or a combination of these components. There is no conceptual difference between taking a view on all components by buying the instrument or entering a derivative contract that replicates ownership, or taking a view on one or a combination of the components via derivatives. There is no conceptual difference between taking a view on the direction of movement (as with simply long and short positions) or taking a view on the magnitude or timing of movements, or other components.

- c) Multi-derivative or hybrid strategies should not be unbundled. Given the wide range of situations this principle can apply to, three examples are set out below. These are intended to be illustrative and not a definitive list.

In all cases involving any such “bundling” HMRC would expect there to be evidence that the transactions were executed in pursuit of a clear prior strategy.

(i) Two or more derivatives

Where, for example, the view is that the price will increase but only within a certain band, and the most efficient way to express that single view is via a series of derivative transactions, those transactions should be considered as a whole and not each in isolation.

(ii) A derivative and another financial asset (e.g. shares)

Where the view is that an asset would not be acquired at current value but would be at a set lower value, a put option is written at that lower value, i.e. as a cost efficient method of acquisition. The writing of the option and the potential acquisition of the asset should be considered as a whole and not each in isolation

(iii) A sequential series of similar derivative strategies

A derivative that is close to maturity generally has greater liquidity than a derivative identical in every way, other than having a longer period to maturity. ‘Rolling’ short dated derivative strategies such that there is a sequential series of similar derivatives should be viewed as a whole and not each in isolation.

8. In HMRC’s view, none of the above approaches is of itself indicative of trading. Taking short positions is no more or less likely to constitute trading than taking long positions, and neither is using synthetics to express views on all or any of the components of risk associated with an asset or index. Such approaches may constitute investment in themselves, or form part of an investment strategy.