

The Impact of the Potential Financial Innovation on Chinese Taxation System and an Analysis

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Abstract

The widespread use of innovative financial transactions in international financial market in recent years is primarily driven by the need for greater financial risk management by businesses and financial investors. Many related factors have contributed to the needs of business for more sophisticated financial instruments, as well as to the financial world's technological ability to meet that demand.

Developments in international financial markets that have influenced this dramatic change include the following: (i) Increased volatility of interest, currency exchange rates and commodity prices; (ii) Expansion in scope of multinational operations of corporations; (iii) Deregulation of financial markets; (iv) Elimination or liberalization of exchange controls; (v) Increasing speed and efficiency of transmission of information.

In fact, Chinese financial instruments were generally limited to securities that could be classified as either debt or equity investments at the time being. Chinese taxation rules presumed a sharp distinction between these two forms of instruments. In particular, it was assumed that debt provide for a relatively fixed return of income and principal, whereas returns on equity investments are contingent on the performance of the issuing corporation. These classifications lead to tax rules reflecting differences in the timing and character of the income from these discrete classifications.

Introduction

The explosive growth in the use of new financial products during the last several decades in the world financial market has revealed an underlying weakness in the above assumptions. Both the development of new instruments and the application of financial engineering techniques to the existing financial products have demonstrated that the risk-return relationship between debt and equity is a continuum rather than a difference in kind. One of the factors that fueled the breakdown of traditional debt/equity distinctions was the development of securities that combined elements of both categories. Examples of such financial instruments include perpetual debt, equity notes, bonds with equity warrants and convertible debt.

Derivative instruments and other innovative financial instruments serve legitimate business and investment purposes. The holder can use such products either to take a position carrying specifically defined opportunities for profit, or to offset the inherent risks of other investments or business activities. Therefore, the ability to shift, substitute, or transform risks through the use of financial products is an essential tool of modern business and investment.

Since China has entered into the World Trade Organization, China will exercise its promise to open the financial market to foreign investment gradually according to the timetable agreed upon. In fact, Chinese financial market is under the way of integrating into the world market to a larger extent. Consequently, the financial innovation will take place soon and more and more innovative financial products will come to the financial market to enrich the diversity of Chinese financial instruments. Furthermore, this potential change may affect Chinese taxation, accounting and financial activities significantly.

In general, domestic tax legislation lags behind developments in the financial markets, with the consequence that domestic tax treatment of financial instruments is often uncertain. In the case of China, tax rules and policies that were developed to address more traditional financial instruments are not suitable to deal with modern financial instruments. This posts considerable challenges for Chinese taxation systems and reform of the relatively rigid taxation system becomes not only imperative but also possible.

Overview of Innovative Financial Transaction

Financial innovation consists of a broad group of financial instruments, referred to as “derivative” contracts. Financial derivatives call for specified cash flows to be made between the counter parties overtime. Unlike traditional debt and equity securities, the derivatives generally do not involve a return on an initial investment. Rather, they are constructed and priced by reference to values “derived” from an underlying security, index, commodity, or other asset, and their value fluctuates with the market movement of that referenced asset.

The basic building blocks of derivative instruments—futures, forward contracts, options and swaps—can be combined in any number of ways as specified by the counter parties. In particular, derivative contracts can separate each of the discrete economic attributes of a particular position or recombine them into new forms. Significantly, they can also be constructed to replicate any specified set of economic attributes in a variety of ways.

In general terms, derivative instruments are constructed from two basic types of contracts: (I) contracts that provide for fixed contractual rights that will be executed in the future are referred to as “forward contracts”, “futures contracts” and “swap”; (ii) contracts that are contingent on one party’s decision to execute in the future are referred to as “option contracts”. These basic building blocks are used in both developing and pricing the numerous derivative products available on the financial market today.

An agreement consisting of a series of options can provide for multiple payments depending on movements in the underlying asset during specified periods. In a “cap” agreement, the purchaser will receive periodic payments whenever the underlying asset price rises above the level specified in the agreement. Similarly, a “floor” agreement will provide the purchaser with payments whenever such value drops below the specified level. A “collar” agreement protects both parties through a combination of a cap and a floor.

In addition, certain notional principal financial arrangements, such as equity swaps, are designed to have the general economic effect of a leveraged purchase of underlying securities. When the index referenced in the swap consists of a single stock, the contract challenges the notion of whether the holder should be treated as an “owner” of the underlying stock itself for tax purposes. Such contracts can also be used by the counterparty to offset the economic benefits and burdens of equivalent shares that the counterparty continues to hold, similarly raising ownership question.

Not surprisingly, at the heart of the financial innovation is the aggregation and disaggregation of some basic types of rights and obligations to create new sets of rights and obligations. For example, an interest rate swap is economically equivalent to a series of cash settled interest rate forward contracts; caps, collars and floors are options based on interest rates; a swaption is an option on a swap and so on so forth.

Together with “physical” securities such as debt and equity, forward contracts and option contracts form the basic building blocks for financial transactions. The rights and obligations involved can be combined in various ways with the result that cash flows can, for example, be (i) certain as to amount, timing and direction; (ii) certain as to timing and direction but not amount; (iii) certain as to timing but not direction or amount; (iv) contingent on a specific event.

Furthermore, under the “put-call parity” theorem¹, there is a fundamental relationship among the value of debt, stock, and put and call options with respect to the stock. That theory leads to the following relationships:

$$\text{Equity} + \text{Put Option} = \text{Debt} + \text{Call Option}$$

This put-call parity framework is central to the pricing methodology for swaps and other derivatives. The ability to “replicate” one instrument type through a combination of others presents a significant challenge to any tax system that bases the income tax treatment of financial products on tradition classifications.

The Challenges for Chinese Taxation Systems

Innovative financial instruments raise a number of issues and problems for the development and administration of an income tax system. They not only present new challenges with respect to the Chinese tax issues of character, amount, timing and source; in addition, they raise wholly new questions regarding the most basic classifications on which Chinese tax rules are based. Moreover, unique issues are presented by the need to eliminate artificial tax barriers on

the legitimate use of risk management tools, while at the same time reducing potential tax arbitrage opportunities.

Chinese income tax issues of character, source, and the timing and amount of income are based on an initial classification of the type of income in question. These systems of categorization are difficult to maintain and administer given the emergence of instruments that can mirror economic attributes of investments in any number of diverse forms. Similarly, the fundamental distinctions in Chinese income tax systems between debt and equity are challenged by instruments providing for returns and risks that are economically equivalent to the financial attributes of debt and equity investments, or any “hybrid²” combination thereof.

Perhaps the most fundamental challenge to Chinese tax systems from the use of innovative financial instruments is their ability to replicate the economic properties of other instruments. A combination of financial products that closely reproduces the economic attributes of an existing instrument is generally referred to as a “synthetic³” tool of the existing instrument. Similar issues are presented by transactions that combine only selected attributes of different instruments to create new “hybrid” forms of financial transactions.

To the extent such strategies can be implemented, they present the possibility that any distinction for tax purposes between traditional classifications will be fully elective for taxpayers. In other words, instruments can be designed to replicate any desired set of economic attributes. Tax attributes, however, could be independently crafted into the instrument to obtain the most advantageous results.

These potential advantages would be particularly clear where the parties to the synthetic or hybrid instrument were not subject to offsetting tax constraints. For example, if one of the parties was a tax-exempt entity or had losses that could fully absorb current income, it would be easier to implement a transaction that shifted tax benefits to the other party resulting in a reduction of the total tax obligation. Similarly, where the rules of two jurisdictions classify the transaction differently, cross-border instruments can be structured to maximize tax advantages with respect to both taxation systems.

The critical issue of determining the “owner” of an instrument for tax purposes is also tested by contracts that replicate, shift or eliminate some or all of the returns and risks of an investment. On the other hand, securities lending and repurchase arrangements that transfer legal title but retain economic attributes of an investment present similar problems of identifying the “tax owner” of a financial position.

Chinese tax system is will also be challenged by two broad and sometimes competing concerns: A. Removing artificial tax barriers to effective risk management strategies; B. Limiting the opportunities for tax arbitrage⁴.

Specifically, tax arbitrage involves taking advantage of differences in the tax treatment, either of persons undertaking transactions or of the transactions themselves, where these differences arise either as a result of the asymmetries within or between tax systems or as a consequence of the specific tax position of the persons themselves. In many cases, tax arbitrage transactions are entered into merely to obtain tax benefits, and have no significant business or financial effects apart from such benefits. Accordingly, the term “arbitrage” broadly refers to any type of abusive transaction that may be available with respect to each of the categories of issues described above. If Chinese tax system does not include adequate rules to prevent such abuse, taxpayers could easily construct arbitrage transactions to maximize the tax benefits of character, timing, source, ownership, or hedging rules.

As a matter of fact, innovative financial transactions have expanded the opportunities for tax arbitrage. Particular concerns are presented by synthetic and hybrid instruments that carry tax attributes of one classification of investment, but provide the economic risks and returns of a different classification.

Chinese Tax Policy Goals

The aim of Chinese tax system is to raise revenue as neutrally, simply and equitably as possible in order that the government has a sound financial base to stimulate the growth of the national economy. To be specific, Chinese tax system is targeting the following goals⁵:

Neutrality and Equity

Tax neutrality fundamentally requires that transactions with the same economic substance attract the same tax treatment. Non-neutrality is evident when tax laws are based on the legal form rather than the economic substance of the transaction. This is particularly so for financial transactions, which can be easily structured in many different ways, without altering their non-tax economic effects.

Efficiency

The goal of efficiency should take into account the ease or difficulty in administering the law as well the taxpayers' costs in complying with it. Compliance by taxpayers is affected by the degree of certainty in the law and the clarity of the concepts. Cost of compliance is also affected by the amount and type of information that taxpayers must keep or produce to meet their tax obligations, as well as the degree of difficulty for tax authorities to verify taxpayers' claims.

Government Revenue Enhancing

Chinese government has broader obligations than other that of many other countries, for example, the United States. Government revenue plays a crucial role in supporting Chinese government to pursue its macroeconomic policy objectives. In order to enhance government revenue, the tax rules must be certainty and robust. Tax rules must also be both broad and flexible in order to address new transactions and variations of existing transactions. To the extent the rules are crafted to reflect the general economic structure of the transactions at issue, they are more likely to impose an appropriate level of income tax on the parties with respect to new transactions as well. The ideal is a set of broad rules that are sufficiently flexible to reflect market activity and facilitate innovation, yet resistant to easy manipulation for taxation advantage.

Chinese Taxation Policy Options

Tax systems that have addressed the financial innovation issues have adopted a number of different approaches, which could serve as the alternatives of policies for Chinese tax system when determining appropriate methodologies to cope with these challenges. The taxation reform approaches can be classified as follows:

Reliance on Financial Accounting Rules

Aligning the tax and financial accounting treatment of innovative financial transactions can in some cases offer greater consistency and reduced the compliance costs involved in the taxation process. Financial accounting standards, however, are far from settled in this area, and in some circumstances allow greater subjectivity and discretion than would be acceptable for tax purposes.

Bifurcation⁶

Tax bifurcation approach relies on the disaggregation of financial instruments, treating each of their discrete economic components separately for income tax purposes. The purpose is to isolate and identify each element with the goal of applying tax rules consistently to the particular components. This goal is often frustrated in practice, however, since there is relatively little agreement on the appropriate method of bifurcation, or on the taxation of the constituent elements.

Integration

Some tax systems allow taxpayers the election to “match” the tax attributes of their “hedging⁷ instruments” with the attributes of specified business or investment transactions. By integrating two offsetting positions, the income tax

system permits the hedging strategy to be effective on an after-tax basis. Similarly, some tax systems impose mandatory integration of certain offsetting transactions to prevent potential abusive transactions. In each case, integration of transactions raises difficult issues regarding scope of the rules and identification of appropriately “matched” transactions.

Mark-to-market Systems

Many of the timing and classification problems can be avoided to the extent that a mark-to-market system applies for income tax purposes. Under such an approach, financial instruments are treated for income tax purposes as if they are sold at year-end, and all resulting gain or loss is taken into account. Difficulties in making such systems work in practice include valuation of illiquid positions and the cash flow problems resulting from imposition of tax effects in advance of market transactions.

However, where a mark-to-market system is limited to particular sectors that have adopted the method for accounting purposes, its expansion to cover taxation may offer an appropriate measure of profits and losses without the numerous practical concerns associated with bifurcation and integration methods.

Anti-Abuse Measures

Some tax authorities have applied broad anti-abuse rules that impose “substance over form” rules to combat tax arbitrage. To the extent such rules target specific abuse transactions they are often adopted too late to be effective. On the other hand, broad rules that give tax authorities discretion to consider the “facts and circumstances” may result in uncertain and inconsistent administration of the rules.

As long as asymmetries of tax treatment exist within and between tax systems there will be scope for tax arbitrage arrangements between unrelated persons. Governments will therefore need to continue to police their system and react to the taxation abuses. The governments can also consider taking more positive steps to restrict tax arbitrage opportunities to the extent that these activities involve obtaining treaty benefits.

Conclusion

Innovative financial transactions have become essential tools of investment and risk management. Through their ability to separate, replicate, and recombine economic attributes into new forms of transaction, financial instruments enable the financial participants to shift and redistribute their financial risks. Indeed, the growing sophistication of these transactions has been driven by the demands from business and financial markets for more effective risk management.

These developments, however, raise serious challenges to Chinese income tax systems, involving issues of the character and source of income, the timing of income and deductions, treaty classification of payment streams, and identification of the owner of financial instruments. Moreover, the greater flexibility afforded to taxpayers by such transactions has expanded opportunities for tax arbitrage, which could undermine the financial market efficiency.

All of the above taxation reform approaches should be considered, either individually or in combination, in developing Chinese appropriate responses to the challenges present by innovative financial transaction. Particularly, bifurcation and integration appear to be contrasting processes: bifurcation divides transactions into small components; integration combines transactions into a composite whole. Yet they derive from the same logic: to establish what, in substance, is happening in terms of the debt/equity/derivative trichotomy. Accordingly, they can logically operate together in appropriate circumstances.

New tax rules designed to meet these challenges must address the overall tax policy objectives of neutrality and equity in order to promote the efficiency of the financial markets as a whole and protect the revenue base for government at different levels at the same time.

It is important to be clear that this must be accomplished, however, with appropriate attention to the goals of certainty and administrability. Moreover, as the use of new financial products continues to expand, they will

inevitably test the viability of the fundamental rules and classifications on which income tax systems and international tax agreements are currently based.

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End Notes

1. Put-call Parity theorem states a fundamental relationship between debt, stock, and options to purchases or sell such stock. It lies down the foundation for financial analysts to integrate or disintegrate innovative securities for form a new financial instrument with the desired economic attributes. For the derivation of this theorem see Charles W. Smithson, Clifford W. Smith, Jr., D Sykes Wilford: *Managing Financial Risk*, pp293-96.
2. A hybrid security is created by combining two types of securities: typically a standard debt or equity security and an OTC derivative—a forward contract, a swap, or an option. For example, puttable bond is a hybrid security, which consists of a standard bond and a put option.
3. Synthetic instrument is created by two or more existing financial tools to obtain the attribute of a desired security. For example, a long call option together with a short stock gives out a long put option.
4. Tax arbitrage enables the firm to earn a risk-free profit by exploiting differences in tax environments. For example, with the introduction of swaps, a Chinese firm could issue a yen-denominated debt in the Eurobond market, structure the issue to receive favorable tax treatment under the Japanese tax code, avoid much of the Chinese securities regulation, and yet still manage the firm's currency exposure by swapping the transaction back into RMBs.
5. For more details of Chinese tax policy goals see Chapter 2: The Functions, Roles and Principles of Taxation, pp35-61, Liu Xiaochuan, *National Taxation*, Nanjing University Publishing House, 1999.
6. Under a bifurcation approach, each of the elements would be valued and subject to income tax separately.
7. Hedging refers to the investment in an asset, usually a derivative instrument, to offset the risk of the underlying asset in order to reduce the overall risk of a portfolio.