Convertible bonds
A multijurisdictional tax survey
Introduction

Convertible bonds are hybrid securities – combining both debt and equity features – involving the issue of a debt instrument with an option for the investor to convert it into shares in the issuer at a predetermined price. Typically, convertible bonds are issued at lower interest rates than non-convertible bonds reflecting the additional value represented by the equity option (allowing investors to benefit from any increase in the share price above the strike price). Given the backdrop of current markets – where equity prices are thought to be undervalued and many corporates and financial institutions need to raise funds cheaply – convertible bonds seem to be attractive to both issuers and investors. Certainly, there have been a number of high-profile issuances in the capital markets recently.

Most jurisdictions tend to tax debt and equity differently. However, that treatment may not be the same across different jurisdictions. Moreover, where hybrid instruments (such as convertible bonds) are concerned, there may be differences not only between how jurisdictions tax debt or equity but also as to how they classify an instrument (or components of that instrument) as between debt or equity (the accounting treatment often being relevant both to classification and tax treatment). Differences in treatment can give rise to planning opportunities, allowing issuers access to even cheaper funds (by leveraging tax deductions) and/or allowing investors a tax-enhanced return.

This brochure provides a high-level outline of the tax treatment in relation to convertible bonds for issuers and investors in some of the key jurisdictions in which we practise tax. Among the points considered are the tax treatment of interest payments and the tax consequences of a conversion of the bond into shares or a cash redemption or settlement. Where relevant, we have included a summary of the expected accounting treatment under applicable local generally accepted accounting principles (GAAP), to facilitate the understanding of the tax treatment.

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Austria

Convertible bonds – Austrian resident issuer

Issue of convertibles (including mandatory convertibles)

Austrian GAAP accounting
- Usually shareholder resolution on contingent capital, (alternatively acquisition of treasury stock).
- Bifurcation of the convertible into a bond element and conversion option.
- Bond element accounted for as debt at (nominal) repayment amount.
- In case of no or below market interest rate consideration for conversion option calculated on the basis of market interest rates.
- Conversion option accounted for as a capital reserve.
- In case of no or below market interest rate, a disagio in the amount of the difference between the higher repayment amount and the pure bond element may optionally be accounted for and depreciated evenly over the financial years until maturity.
- Interest payments accounted for as interest expense.

Austrian tax issues
- Austrian tax accounting corresponds to Austrian GAAP accounting with the exception that the accounting and depreciation of a disagio is mandatory in case of no or below market interest rates.
- Interest payments generally deductible for Austrian tax purposes.
- Neither tax liability nor withholding tax (WHT) if interest is paid to non-resident.
- Potential Austrian stamp duty unless inter alia the convertible is offered to the public via public or private placement.

Conversion at maturity

Austrian GAAP accounting
- Generally, increase of nominal share capital in an amount that corresponds to nominal amount of the bond element (alternatively, exchange of bond element against treasury stock and increase of capital reserve).
- Neutrality of consideration for conversion option, which remains accounted for as a capital reserve.

Austrian tax issues
- Austrian tax authorities consider the conversion an exchange of bond element against new shares, however, in case of an increase of the nominal share capital, tax neutral irrespective of the fair market value of the pure bond element.
Potential taxable gain in the absence of an increase of the nominal share capital since Austrian tax law would only treat the recoverable part of the bond element a tax-neutral contribution (accounted for as a capital reserve).

Consideration for conversion option tax neutral.

One per cent Austrian capital tax on nominal amount of bond element upon conversion.

No conversion at maturity

Austrian GAAP accounting

- Repayment of bond element.
- Neutrality of consideration for conversion option, which remains in capital reserve.

Austrian tax issues

- Tax-neutral repayment of bond element.
- According to Austrian tax authorities consideration for conversion option accounted for as a profit, however, good arguments for tax neutrality based on German case law on comparable tax law provisions.

Convertible bonds – Austrian corporate investor in convertible

Issue and holding of convertible (including mandatory convertibles)

Austrian GAAP accounting

- No bifurcation of the convertible into a bond element and conversion option.
- Accounting for the bond as a financial asset (or short-term asset) at acquisition cost.
- Accrued interest and interest payments accounted for as income.
- Valuation of the bond at each balance sheet date pursuant to the lower of cost or market in case of durable reductions in value (in case of short-term assets irrespective of whether the reduction in value is expected to be durable).

Austrian tax accounting

- Bifurcation of the convertible into a bond element and conversion option.
- Accounting of the bond element at acquisition cost; in case of no or below market interest rates recalculation of the acquisition cost of the bond element for Austrian tax purposes based on market interest rates.
- Accounting of the conversion option at acquisition cost for Austrian tax purposes.
- Accrued interest and interest payments (including the difference between the acquisition cost of the bond element for Austrian tax
purposes and a higher redemption amount in case of no or below market interest rates) generally taxable.

- Valuation of the bond element at each balance sheet date pursuant to the lower of cost or market in case of durable value reductions (in case of short-term assets irrespective of whether the reduction in value is expected to be durable).

**Conversion at maturity**

**Austrian GAAP accounting**

- Exercise of conversion option leads to acquisition of new shares.
- Accounting of the new shares at the book value of the convertible bond.
- No capital gains for accounting purposes.

**Austrian tax issues**

- Exchange of bond element against new shares.
- Accounting of the new shares at the fair market value of the bond element plus acquisition cost for tax purposes of the conversion option.
- Potential taxable gain amounting to the difference between the book value of the bond element and the fair market value of the bond element.

**No conversion at maturity**

**Austrian GAAP accounting**

- Repayment of the bond.

**Austrian tax issues**

- Tax-neutral repayment of bond element.
- Tax deductible write-off of the conversion option.
Belgium

Convertible bonds – Belgian resident issuer

Issue and lifetime of convertible

Legal framework

- Only limited liability companies (SA/NV, SCA/CVA) can issue convertible bonds.
- The issuance is subject to detailed rules under the Belgian Company Code because the decision to issue convertible bonds may lead to a future capital increase of the company, which is generally a prerogative of the shareholders.

Belgian accounting

- This issue has been addressed by the Accounting Standards Commission (ASC) in its (non-binding) advice 139/8.
- Both a single instrument as well as a split accounting or building blocks approaches have been approved by the ASC.
- Under the first approach, only the reduced financing cost is reflected in the accounts of the issuing company. The potential downside for the shareholders, i.e., the dilution of their shares, is not reflected in the accounts. Neither the share capital, nor the results of the company are influenced by it. The convertible bond must be booked as a debt obligation at its issue price.
- Under the second approach, which follows the International Accounting Standards Committee (IASC) norm 32, the issue price of the bond must be bifurcated on the liabilities side of the balance sheet into the value of the option and the bond component. On the one hand, the present value of the difference in interest rate between the actual (lower) rate of the convertible bond at stake and the market rate of a comparable straight bond must be accounted for as an issue premium. On the other hand, the present reimbursement value of the loan of the convertible bond must be accounted for as a debt obligation. During the lifetime of the bond, the amount of the issue premium is added on a pro rata basis (depending on the accrued interest) to the liability account ‘bond/debt obligations’ of the balance sheet.
- It should be noted that the split accounting method is the preferred one by the ASC because this approach provides a better reflection of the financial reality and the intentions of the parties.
- The split accounting method should also be used for bonds cum warrant and subscription rights. Mandatory convertible bonds (obligations remboursables en actions – ORAs) however, can only be booked according to the single instrument approach.
- With regard to the valuation of the convertible bond, lower of cost or market principles should be applied in Belgium. This means that, unless the market value would be lower, the historic cost or
acquisition value should be used when booking the instrument. With regard to the returns yielded by the convertibles, convertibles should be considered as variable-income\(^1\) instruments and, as such, should be recorded using a ‘wait and see’ approach. Under this approach, when evaluating the securities, depreciations and devaluations should be deducted from the historical cost. These two principles should always be kept in mind when booking convertibles.

**Belgian tax treatment**
- The issue of convertible bonds is executed before a notary public and recorded in a deed. At the time of the issue, no proportional capital duty or registration rights are imposed.
- The coupons paid are classified as interest and are tax deductible (both the nominal interest as well as the differential against the market interest rate under split accounting) as professional costs.\(^2\)

**Maturity (conversion or repayment of principal)**

**Legal framework**
- The conversion is split up into two successive operations for legal as well as for tax purposes. Firstly, the repayment of the debt takes place. Secondly, a cash subscription to a capital increase takes place.

**Belgian accounting**
- Booked under share capital or partly under share capital and partly under issue premium depending on whether one opted for the single instrument approach or the split accounting system.
- Whether or not the bond holders do or do not invoke their conversion rights, the issue premium account on the liabilities side of the balance sheet keeps recording the same number as it does from the date of the issue of the convertible.
- The issuer should value the shares for the nominal value of the capital increase.

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\(^1\) As neither the Belgian legislator nor the ASC has been defining instruments generating fixed and variable income, Belgian practice looks at the predictability of the income, which is a factual approach. If the final return cannot be calculated from beforehand, the instrument should be considered as a variable income generating instrument.

\(^2\) Two recent rulings (4 May 2006 and 5 June 2007) have confirmed that convertibles classify as debt rather than equity under Belgian tax law, that the compensations made to the bond holder qualify as interest under article 19 §1, 1° of the Belgian income tax code (BITC) and that those interests are tax deductible as professional costs under article 49 of the code. In addition, the ruling specified that the compensations/coupons paid to the bond holders do not qualify as so-called abnormal and gratuitous benefits under article 26 or 207 §2 of the BITC. As such, the global interest formula should be at arm’s length; the actual interest rate during each year is not at stake. (Finally, the rulings also confirmed that articles 54, 55 and 198 al.1, 11° of the BITC are not applicable to convertibles. These are articles that limit the possibility of deducting interest.)
Belgian tax treatment

- At the moment of conversion, no proportional capital duty or registration rights are imposed on the nominal capital increase.

- Income distributed after conversion is qualified as dividend and added to the taxable basis of the corporation and, as such, is subject to Belgian corporate tax.

- Moreover, a withholding tax is levied on such dividends at the standard rate of 25 per cent. However, for dividends issued after 1 January 1994, the withholding tax has been reduced to a level of 15 per cent. With respect to publicly issued shares, the lower rate can only be applied to the dividend if no other privilege has been attributed to other issued shares of the corporation. For privately issued shares, the shares must moreover have been subject to a registered subscription or an overdraft deposit in Belgium and must have been paid for in cash.

- It should be noted that, under the parent-subsidiary directive, dividends may be exempted from Belgian withholding tax provided that the paying as well as the receiving corporations are subject to corporate tax (or a similar tax) and provided that the receiving corporation has for one year had a continuous participation of at least 10 per cent in the capital of the paying corporation. Such exemption applies not only in a European Economic Area (EEA) setting, but also if the parent company is located in a third country with whom Belgium has concluded a double tax treaty.

- If the parent-subsidiary directive is not applicable, the dividends will be subject to withholding tax. However, for Belgian corporate investors such withholding tax is creditable or refundable under article 281 of the BITC, provided that the shares were in the entire property of the receiving company when the dividends were issued.

- Under article 282 of the BITC, no exemption of the withholding tax is available if the distribution of dividends leads to a (significant) depreciation of the underlying share.

- Moreover, it should be noted that double tax treaties often provide for reductions/exemptions of the applicable withholding tax.

- If the bond is not converted, no taxable event takes place for the issuer provided that the issue premium is maintained in an unavailable account.3

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3 It is debatable whether or not the issue premium can be kept under a capital premium in an unavailable account and, as such, remain tax exempt, or whether it should be transferred to a distributable reserve that is subject to a tax treatment.
Convertible bonds – Belgian resident corporate investor

Issue and lifetime of convertible

Belgian accounting
- Belgian accounting law does not allow an investor of convertible bonds to adopt the split accounting method. As there is no ASC advice for investors of convertible bonds with regard to split accounting, a single instrument approach should be used.4

Belgian tax treatment
- Accruals of interest are taxable through a withholding tax of 15 per cent when the interest is attributed or made available. Successive bond holders are taxed in proportion to the period during which the bonds are held.
- If the bond is sold before the date of maturity, capital gains realised are subject to Belgian corporation tax. Losses should be deductible.

Maturity (conversion or repayment of principal)

Belgian accounting
- The investor should value and account for the shares based on the market value of the shares.

Belgian tax treatment
- Capital gains (ie the difference between the market value of the shares received in consideration for the contribution and the amount contributed) realised at the moment of conversion are subject to corporate income tax.
- The receiver of revenues after conversion of the bond may, under certain circumstances, take advantage of the dividend received deduction (DBI/RDT) applicable to dividends. Under this rule, only 5 per cent of the total amount of the received dividends will be subject to corporate tax. This deduction cannot be carried forward to subsequent taxable years. Two categories of conditions must be met: a quantitative and a qualitative (defined in articles 202 and 203 of the BITC). Quantitatively, the receiving corporation must own a participation in the capital of the subsidiary representing at least 10 per cent of the share capital (or having an acquisition value of at least €1,200,000). Qualitatively, the receiving corporation must be subjected to Belgian corporate tax or a similar foreign tax. Furthermore the amount of the deduction is limited to the total amount of taxable gain remaining after the first three calculations and reduced by the rejected expenses (under article 205 of the BITC).

4 It should be noted that several authors state that a split accounting system can be used based on the IAS norms. However, no institutional confirmation is yet available and therefore a more conservative approach should still be adopted.
Since the Cobelfret case (a case involving the compatibility of the Belgian dividends received deduction regime with the EC Parent-Subsidiary Directive) rendered by the Court of Justice dd 12 February 2009, the dividends received deduction for dividends distributed between corporations within the EEA that surmount the taxable gains in the given taxable year, can be carried forward to the following taxable years, in accordance with article 4, section 1 of the parent-subsidiary directive.

Capital gains realised on a sale of the shares should be fully tax exempt, provided that the subsidiary meets the subject-to-tax test. Capital losses will not be tax deductible.
France

Convertible bonds – French resident issuer

Issue of convertible bonds (including mandatory convertibles)

French GAAP accounting (statutory entity accounting rules)

- No bifurcation between bond element and conversion option.
- The issue price of convertible bonds with no (issuance or redemption) premium is accounted for as debt.
- In case of convertible bonds with premium, two solutions are possible (the second one is more frequently used):
  (i) the entire amount repayable at maturity (including the premium) is accounted for as debt, and the premium is accounted for as an asset which is amortised (pro rata to accrued interest, or straight line over the bonds’ maturity); or
  (ii) the issue price (excluding the premium) is accounted for as debt. On each year-end (balance sheet) date prior to maturity (or early repayment) of the bond, the issuer needs to evaluate the risk of payment of the premium (i.e., the risk of non-conversion) and book a corresponding provision (for the after-tax amount of the risk for the issuer).
- Accrued interest coupons are accounted for as financial expenses.

French tax treatment

- Tax classification (generally) follows classification under commercial law and accounting rules, convertible bonds (including mandatory convertibles) should be classified as debt for tax purposes. However, increased scrutiny by tax authorities may restrict ability to provide for too many equity-like features.
- No bifurcation between bond element and conversion option.
- Interest (coupons) deductible under general rules, including:
  - arm’s length requirement (market-level interest rate, taking account of conversion option); and
  - thin capitalisation rules where issuer and holder are related parties.
- Convertible bonds with premium:
  - the premium is deductible only if and when it is paid (in particular, no accrual of premium permitted at issuer level for convertibles – French tax code, § 39-1-1° ter);
  - if the issuer has elected to account for the bond as described at (i) above the amortisation of the premium is not deductible (BOI 4 C.3-93, # 13);
  - if the issuer has elected to account for the bond as described at (ii) above, unclear whether provision is deductible (no case law or guidelines from the tax authorities on this question). The rule that the premium on a convertible is deductible in the event of
payment only (see above), and the provision being for the after-tax amount of the premium (see (ii) above), would point to non-deductibility).

Conversion at maturity

French GAAP accounting
Convertible bonds without premium:
- the relevant debt account is neutralised and share capital is increased for a corresponding amount (with, as the case may be, accounting for a conversion premium equal to the difference between the aggregate par value of the issued shares and the amount of debt which is neutralised).

Convertible bonds with premium:
- if the issuer has elected to account for the bond as described at (i) above, the relevant debt account is neutralised, and two solutions are possible to account for the share capital increase (the first one is more frequently used):
  - share capital increase for an amount corresponding to the repayment amount excluding the premium accounting of a conversion premium for an amount corresponding to the amortised portion of the repayment premium, and cancellation of the unamortised portion of the premium; or
  - share capital increase for an amount equal to the bond issue price (excluding the premium) accounting of a financial product corresponding to the amortised portion of the premium, cancellation of the unamortised portion of the premium;
- if the issuer has elected to account for the bond as described at (ii) above: neutralisation of the relevant debt account and share capital increase for a corresponding amount (the premium is offset against the conversion premium).

French tax treatment
- Conversion of bonds into shares is tax neutral for the issuer.
- No ad valorem stamp duty.

No conversion at maturity

French GAAP accounting
- Neutralisation of the relevant debt account by debit of the cash account.
- Convertible bonds with premium: accounting of a financial expense equal to the premium paid (with cancellation of the corresponding provision, if any).
French tax treatment

- Repayment of the convertible bonds is tax neutral.
- Convertible bonds with premium: the financial expense corresponding to the premium paid is tax deductible.

Convertible bonds – French corporate investor

Issue and holding of convertible bonds (including mandatory convertibles)

French GAAP accounting (statutory entity accounting rules)

- Convertible bonds are accounted for as fixed financial assets or trading securities (depending on the purpose of the investment: holding or trading, respectively), at their acquisition cost.
- No bifurcation between bond element and conversion option.\(^5\)
- Issuance or redemption premiums (if any) are not accounted for (generally) by the investor at acquisition.
- Accrued interest is accounted for as financial income.
- General accounting rules apply at year-end (investor’s balance sheet date): need to book a provision in case of impairment in value of the convertible bonds (even if the bonds are intended to be held until maturity).

French tax treatment

- No bifurcation between bond element and conversion option.
- Accrued interest is ordinary income for corporate income tax purposes.
- Provisions for depreciation of the convertible bonds (if any) are tax deductible subject to standard conditions.
- Convertibles with (issuance or redemption) premium: subject to standard original issue discount (OID)-type rules, ie, the investor is required to accrue the premium until maturity, conversion or redemption of the bonds. In summary:
  - rateable inclusion of premium (in investor’s ordinary income) where (i) premium (defined as any amount payable to the investor at or prior to maturity other than non-contingent, periodic interest) exceeds 10 per cent of acquisition price and (ii) average issue price is 90 per cent or less of final redemption amount; and
  - inclusion applies pursuant to the constant yield-to-maturity method, except where the instrument has a contingent feature, in which case a statutory floating reference rate is used (but a bond is not deemed to be contingent simply because it is a convertible).

\(^5\) Except where the conversion option is embedded in a separate security: ie, case of bonds with share warrants attached (obligations à bons de souscription d’actions). This situation is not discussed further in this note.
**Conversion at maturity**

**French GAAP accounting**
- Conversion is generally treated as an exchange, triggering recognition of capital gains or losses (corresponding to the difference between the acquisition price of the convertible bonds and the value of the shares received as a result of the conversion).
- In case of capital gains, generally, no provision for tax is required.

**French tax treatment**
- Capital gains or losses realised at conversion are rolled over until disposal of the shares received as a result of the conversion (filing requirements). Investor takes a transferred tax basis in the shares (equal to the investor's tax basis in the bonds pre-conversion).
- Rollover not applied if boot exceeds (i) 10 per cent of the par value of the shares; or (ii) the investor's gain from the conversion. Boot below both limits does not disqualify the rollover but amount of boot is taxable immediately (ie, in the year of the conversion). Boot includes cash, securities other than shares, and shares with bond warrants attached.

**No conversion at maturity**

**French GAAP accounting**
- Repayment of the convertible bonds by credit of the cash account.

**French tax treatment**
- Repayment of the convertible bonds is tax neutral.
- Bonds with premium: the premium (or, where the OID-type rules discussed above are applicable, the portion of the premium that has not been included in the holder's taxable income prior to repayment) is includable in the investor's ordinary income.

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6 Rollover treatment is mandatory, holder cannot elect immediate taxation or deduction of conversion gains/losses.
Germany

German tax consequences re convertible bonds (including mandatory convertible bonds) – German resident issuer

Issue of convertible bond

Forms of convertible bonds:

- Convertible bonds (*Wandelanleihen*):
  - bonds with embedded creditor’s right to request new shares of the issuing company at a fixed price (capital increase measure) instead of repayment of capital.

- Mandatory convertible bonds (*Pflichtwandelanleihen*):
  - bonds with the creditor’s right to convert bonds into new shares, otherwise mandatory conversion at maturity.

- Exchangeable bonds (*Umtauschanleihen*):
  - *not considered hereafter*: bonds with creditor’s right to convert bonds into *already existing shares* of the issuer/shares of a parent company/third company.

Consequences under German GAAP

- Prevailing view in the literature: corresponding application of the accounting principles for bonds with detachable warrants (*Optionsanleihen*), ie, separate recording of premium for conversion right and liability despite uniform legal relationship.
- *Premium for conversion right accounted for as capital reserve.*
- Where bond is issued with an ‘agio’ and an at market interest coupon, value premium for conversion right equal to agio.
  - Otherwise valuation of the premium for conversion right basically by comparing the below market interest-paying convertible bond with a market rate interest-paying bond of the same issuer without conversion right (residual method).
- Spread between market rate interest-paying bond and actually paid interest can be booked as deferred item on the asset side of the balance sheet and released over the life of the convertible bond.
- Recording of the liability under the convertible bond at the repayment amount (par value).
- Controversial, whether these principles also apply to mandatory convertible bonds. Better view speaks *against* separate recording of premiums received/to be paid by issuer for conversion rights (short call option, long put option), as combination economically comparable to forward sale.

Consequences under German tax accounting principles

- Treatment of convertible bond under German tax accounting principles contentious. Prevailing view adopts GAAP treatment for tax accounting purposes, with the exception that the recognition of
the deferred item on the asset side of the balance sheet is mandatory under tax accounting principles.

**Interest payments/(if applicable) expenses from the release of the deferred item**
- Under German GAAP, interest payments (and, if applicable, expenses from the release of the deferred item) are accounted for as interest expenses.
- For tax accounting purposes, interest payments (including expenses from release of deferred item) are subject to the interest limitation rule, ie only under certain circumstances fully deductible for tax purposes. In addition, interest deduction can be restricted for trade tax purposes.

**Maturity of the convertible bond**

**Conversion of the bond**
- Conversion of bond leads to increase of issuer’s capital (registered share capital and, as the case may be, capital reserve). Profit/loss neutral. Conversion has no bearing on attribution of premium for conversion right to capital reserve.

**Repayment of principal at maturity**
- Repayment of the bond is basically profit/loss neutral. Repayment has no bearing on attribution of premium for conversion right to capital reserve.

**Convertible bonds – German resident corporate investor**

**Acquisition of convertible bond**

**Consequences under German GAAP**
- Prevailing view: bifurcation of the convertible bond into straight bond element and option right (long call).
- Acquisition cost for straight bond equal to acquisition cost for convertible bond less acquisition cost for option right (net method).
  As regard valuation of option right, cf residual method above.
  Write-up of straight bond at the end of each of the investor’s business years. Alternatively: recording with the repayment amount (gross method) and recognition of deferred item on the passive side of the balance sheet (reflecting spread over market rate interest-paying bond).

**Consequences under German tax accounting principles**
- Prevailing view: no bifurcation for tax purposes. Investor has to book a single instrument for German tax purposes.
Interest payments/receipts from the release of the deferred item (if applicable)

- Under German GAAP, interest payments (and, if applicable, receipts from the write-up of the straight bond, release of deferred item) are accounted for as interest receipts.
- For tax accounting purposes, only coupon payments under the convertible bond are accounted for as interest receipts (in line with tax accounting treatment).
- For German resident corporate investor, interest payments received from the issuer of the convertible bond are subject to withholding tax (WHT) (26.376 per cent), which is creditable/refundable for the investor.

Maturity of the convertible bond

Conversion of the bond

- Conversion of bond profit/loss neutral under German GAAP, as book value of straight bond and option right at the point in time of the conversion booked as acquisition cost for received shares.
- This applies mutatis mutandis for tax accounting purposes (book value of convertible bond at the point in time of the conversion is booked as acquisition cost for received shares).
- For German resident corporate investor, conversion is not subject to WHT.

Repayment of principal at maturity

- Under German GAAP profit/loss to the extent that repayment amount exceeds/falls short of book value of bond element and option right.
- Repayment is not subject to WHT in the case of a German corporate investor.
Convertible bonds – Italian resident issuer

Issue of convertibles by adopters of International Financial Reporting Standards (IFRS)

IFRS accounting

- A bond or similar instrument convertible by the holder into a fixed number of ordinary shares of the issuer is a compound financial instrument that, from the issuer’s perspective, comprises two components: a financial liability (the issuer’s obligation to pay interest and, potentially, to redeem the bond in cash) and an equity instrument (the holder’s right to call for shares of the issuer).

- IAS32 requires the issuer to show separately on the balance sheet the liability and equity components (so-called ‘split accounting’).9

- On initial recognition of the convertible bond, the issuer is required to determine the fair value of:
  - the liability component, discounting the projected cashflows at the market interest rate for equivalent debt instruments having no conversion rights; and
  - the equity component as a residual amount (the difference between the total issue proceeds and the liability component as determined above).

- The convertible (the combined instrument) is not itself measured, in the issuer’s accounts, at fair value with changes in fair value recognised in profit or loss.

- The equity component is not subsequently re-measured after initial recognition.

- On the assumption that the liability is not classified as at fair value through profit or loss, the liability component is then measured at amortised cost using the effective interest rate method. Interest is accrued over the life of the convertible bond and recognised as an expense in the income statement. The difference between the initial carrying value of the liability component and its par value accrues over the life of the bond and is recognised among the interest expenses in the income statement.

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7 We are assuming that a fixed number of shares shall be delivered on conversion of the bond (no cash settlement option).

8 Italian banks, as well as listed companies and financial intermediaries enrolled in the so-called 107 Register held by the Bank of Italy, are mandatorily required to adopt International Financial Reporting Standards (IFRS) in their solo financial statements. Other entities may opt to adopt IFRS rather than Italian GAAP.

9 The exposure draft of proposals to improve financial instrument accounting, published by the IASB on 14 July 2009, does not entail any changes to the IAS32 principles dealing with the accounting treatment of a convertible bond by the issuer.
Italian tax treatment

- Italian income treatment generally follows IFRS. Therefore:
  - ‘split accounting’ is recognised for tax purposes too;
  - the interest charge as shown in the income statement (rather than the cash interest paid) should be brought into account for tax purposes; the ordinary rules restricting deductibility of interest expenses apply;\(^\text{10}\) and
  - the equity component should not be taxable upon initial recognition, according to the prevailing view. However, this is a controversial issue.

- Withholding taxes:
  - no withholding tax on interest paid on convertible bonds having a term of at least 18 months; otherwise, there is a 27 per cent withholding tax charge;
  - ‘mandatory’ convertible bonds could be qualified as ‘atypical securities’ (titoli atipici), in which event a 27 per cent withholding tax should apply irrespective of their maturity; and
  - the Italian domestic withholding tax rate may be reduced under applicable tax treaties.

- No Italian stamp duty.

Conversion at maturity

IFRS accounting

- On conversion of the bond at maturity, the liability component is derecognised and transferred to equity with no gain or loss recognised.

Italian tax treatment

- Italian income treatment follows IFRS. Therefore, no gain or loss is recognised upon conversion at maturity of the bond.

- Even though the issue is contentious, equity component should not be taxable according to the prevailing view.

- No Italian stamp duty.

No conversion at maturity

IFRS accounting

- Repayment of bond element.
- Equity element remains accounted for as equity.

Italian tax treatment

- Tax-neutral repayment of bond element.

\(^{10}\) In broad terms: (i) banks can only tax deduct 96 per cent of their funding costs (however, special rules apply to banks that are tax grouped); (ii) for non-banking listed companies, net interest expenses (ie net of interest revenues) are normally deductible up to 30 per cent of the earnings before interest, taxes, depreciation and amortisation (EBITDA).
Equity component should be taxable, according to the prevailing view. Again, this is a controversial issue at present.

**Regulatory treatment**

**Liability component**
- The liability component of convertible bonds directly issued by an Italian bank should likely not qualify as Tier 1 for Italian regulatory capital purposes. Indeed, only the following items are considered as Tier 1:
  - paid-up share capital;
  - reserves (excluding valuation exemptions);
  - innovative capital instruments (such as preferred shares and irredeemable securities satisfying certain requirements);
  - net income for the period;
  - positive Tier 1 capital prudential filters; and
  - when considering the consolidated regulatory capital, minority interest.

- The liability component could qualify as Tier 2 capital if:
  - the convertible bonds have a subordinated nature (if they rank junior vis-à-vis any common creditors of the bank) and an original maturity of at least five years (when there is no set maturity, repayment shall be subject to at least five years’ prior notice); and
  - any automatic step-up clauses associated with early redemption do not take effect until the fifth year of the bond’s life (with the amount of the step-up being capped to 100 basis points (bps)).

- The liability component (not computed in Tier 2) could qualify as Tier 3 capital if the convertible bonds:
  - have a subordinated nature and an original maturity of at least two years (when there is no set maturity, repayment shall be subject to at least two years’ prior notice); or
  - are subject to a ‘lock-in’ clause under which principal and interest may not be repaid where repayment would reduce the overall amount of the bank’s capital to less than 100 per cent of the total capital.

**Equity component**
- The equity component should be a ‘qualifying’ item for Tier 1 purposes.
- Upon conversion of the bond, the entire amount of liability component that is ‘moved’ to equity should be computed in the Tier 1 capital.
Convertible bonds – Italian resident corporate investor

Holding of convertibles by adopters of IFRS

IFRS accounting

☐ Under IAS39, convertibles shall be separately bifurcated into a bond (the 'host contract') and an embedded derivative, provided the following four conditions are met:
  - the economic characteristics and risk of the embedded derivative are not closely related to those of the loan liability;
  - a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative;
  - the derivative component is not transferable independently of the bond to which it is attached (and has not a different counterparty from the bond); and
  - the convertible (the combined instrument) is not itself measured, in the investor's accounts, at fair value with changes in fair value recognised in profit or loss. This fourth condition could be failed (and hence no bifurcation would be allowed) where the convertible is classified as 'held for trading' or where the investor designates it as a 'financial asset at fair value through profit or loss' (on exercise of the so-called fair value option).

☐ If the convertible is measured at 'fair value through profit or loss' (FVTPL) (either because it is treated as a 'held for trading asset' or upon exercise of the fair value option), all changes in value of the convertible shall be recognised in the income statement. Interest on the convertible is accrued over the life of the instrument and recognised as revenue.

☐ If the convertible is not classified as 'fair value through profit or loss' and the other three conditions listed above are also respected, the investor would be required to bifurcate the instrument, separately accounting and measuring the embedded derivative and the bond. More in detail:
  - the initial carrying value of the embedded derivative will be its fair value. Subsequent changes in the fair value of the derivative are then recognised in the income statement;
  - the difference between the initial fair value of the derivative and the overall fair value of the convertible will be the initial carrying value of the bond element. The bond element will then be measured at amortised cost (subject to impairment) or at fair

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11 We are assuming that a fixed number of shares shall be delivered on conversion of the bond (no cash settlement option).
12 Italian banks, as well as listed companies and financial intermediaries enrolled in the so-called 107 Register held by the Bank of Italy, are mandatorily required to adopt International Financial Reporting Standards (IFRS) in their solo financial statements. Other entities may opt to adopt IFRS rather than Italian GAAP.
13 If treated as a 'held to maturity' asset (not feasible where the conversion rights are exercisable before maturity) or as 'loans and receivables' (not applicable where the instrument is quoted in an active market).
value\(^{14}\) (with any changes in value being recognised in equity); and

- interest on the convertible is accrued over the life of the instrument and recognised as revenue. The implicit discount (the difference between the fair value of the convertible and the carrying value of the bond on initial recognition) is also accounted in the income statement as interest and correspondingly increases the carrying value of the bond element (which is then subject, as the case may be, to impairment or to fair value measurement).

**Italian tax treatment**

- Bifurcation of the convertible (if required under IFRS) should be respected tax-wise.\(^{15}\) If no separate accounting is required under IAS39, then no derivative exists for tax purposes.

- If the convertible is measured at FVTPL, any changes in fair value recognised in the income statement should be taxable/deductible. The tax cost of the convertible should correspond to its fair value.

- If the convertible is treated as an 'available for sale' asset:
  - any changes in fair value of the embedded derivative should be taxable/deductible. Accordingly, the tax basis of the derivative should correspond to its fair value;
  - any changes in fair value of the bond element, being recognised in equity, should be disregarded. Accordingly, the tax basis of the bond element should be equal to its initial carrying value as increased with the accrual of the implicit discount (and hence, in certain cases the tax basis may differ from the book value);
  - bifurcation of the convertible (if required under IFRS) recognised for tax purposes too; and
  - investor taxed in respect of the interest revenues as shown in the income statement (rather than the cash interest collected).

- If the convertible is treated as a 'held to maturity' asset or as 'loans and receivables':
  - any changes in fair value of the embedded derivative should be taxable/deductible. Accordingly, the tax basis of the derivative should correspond to its fair value; and
  - the tax basis of the bond element (which is not subject to fair value measurement) should be equal to its initial carrying value as increased with the accrual of the implicit discount (as the bond is not subject to fair value measurement, the tax basis should not differ from the book value).

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14 If treated as an 'available for sale' asset.

15 Doubts may arise where the convertible bond itself qualifies as an equity instrument for tax purposes (in the event that it carries coupons which are proportional to the issuer's profits), which we assume not to be the case for the purposes of the present document.
Investor taxed in respect of the interest revenues as shown in the income statement (rather than the cash interest collected), including therefore the accruing notional discount in case the instrument is bifurcated.

Withholding taxes
- no withholding tax on interest paid on convertible bonds having a term of at least 18 months; otherwise, there is a 27 per cent withholding tax charge;
- ‘mandatory’ convertible bonds could be qualified as ‘atypical securities’ (titoli atipici), in which event a 27 per cent withholding tax should apply\(^{16}\) irrespective of their maturity; and
- investor should in any case be entitled to credit any withholding taxes suffered against its corporation tax liability.

No Italian stamp duty.

Conversion at maturity

IFRS accounting
- On conversion at maturity, the bond (and the derivative, in the case of bifurcation) contract would be derecognised and replaced by an investment in the shares acquired at a value equal to the aggregate carrying value of the bond (and the derivative, if any).

Italian tax treatment
- Tax treatment of conversion controversial. The prevailing view is that conversion of the bond should not represent a taxable event, as long as no gains or losses are recognised in the income statement under IFRS.\(^{17}\)
- The shares should inherit the tax basis of the bond (and of the derivative, if any).
- No Italian stamp duty.

Exposure draft on classification and measurement of financial instruments
- On 14 July 2009, the IASB\(^{18}\) published an exposure draft of proposals to improve financial instrument accounting.
- The proposals, which the IASB believes will significantly reduce complexity and make it easier for investors to understand financial statements, address how financial instruments are classified and measured, amending IAS39 and other IFRSs.

\(^{16}\) If the issuer is an Italian resident company.

\(^{17}\) Tax issues may arise if the fair value reserve is transferred to the income statement upon conversion or in respect of any changes in fair value from the previous measurement date that could be recognised in the income statement.

\(^{18}\) International Accounting Standards Board.
The IASB plans to finalise the classification and measurement proposals in time for non-mandatory application in 2009 year-end financial statements (with no mandatory application before 2012).

Under the exposure draft, the IAS39 classification categories (which represent at present a major source of complexity) would be replaced with two measurement categories: fair value and amortised cost.\(^\text{19}\)

In addition, the exposure draft proposes that one classification approach should be used for all types of financial instruments, including those that contain embedded derivative features. This means that, under the new standard, it would no longer be possible to bifurcate an embedded derivative from its host financial contract. Rather, the combined instrument would be classified, in its entirety, in one of the proposed measurement categories.

The changes in the accounting classification and measurement of financial instruments could also entail the need for the Italian legislator to adopt the current tax rules, which reflect at present the multiple classification categories contained in IAS39.

The tax treatment of a convertible bond holder could, therefore, be affected by the new accounting rules and by any changes or new guidelines that could be enacted by the Italian tax legislator.

\(^{19}\) In addition, the exposure draft would allow an optional alternative presentation for gains and losses on certain equity instruments (such as strategic equity investments).
The Netherlands

Convertible bonds\(^{20}\) – Netherlands resident issuer

Issue of convertibles

Netherlands GAAP accounting

- Usually shareholder resolution on capital needed (alternatively acquisition of treasury stock), often based on proxies.
- In principle, bifurcation of the convertible into a bond element and conversion option is optional, but recommended by the Accounting Board (Raad voor de Jaarverslaggeving).\(^{21}\) However, in certain cases bifurcation is required or prohibited.
- The bond element is accounted for as debt at its amortised cost price (being the nominal value of the bond less any discount).
- In case of no or below market interest rate as compensation for the conversion option or as compensation for a discount in the bond element, a discount in the amount of the difference between the higher repayment amount and the ‘pure’ bond element due must be accounted for as interest expenses evenly over the financial years until maturity.
- The conversion option is accounted for as equity at the difference between the fair market value of the convertible bond and the fair market value of the bond element.
- Interest coupon payments accounted for as interest expense.

Netherlands tax issues

- Netherlands tax accounting in principle does not correspond to Netherlands GAAP accounting but, in practice, the same principles are used.
- Interest coupon payments generally deductible for Netherlands tax purposes (subject to general restrictions on interest deductions).
- In case of no or below market interest rate, a discount in the amount of the difference between the higher repayment amount and the ‘pure’ bond element is not deductible, insofar this discount is attributable to the conversion option.
- No withholding tax is levied.
- No Netherlands stamp duty.

Conversion at maturity

Netherlands GAAP accounting

- All through equity: decrease of the bond element on the balance sheet by its full amount against an increase of the nominal share capital at the nominal bond amount, unless previously repurchased own shares are delivered, in which case the residual reserves

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\(^{20}\) Convertible in shares of the issuer at the option of the holder (no mandatory, reverse or exchangeable bond).

\(^{21}\) Rj 290.813.
(overige reserves) are increased and the nominal share capital remains unchanged.

**Netherlands tax issues**
- The exchange of the bond element for shares is tax neutral.
- Consideration for conversion option tax neutral.

**No conversion at maturity**

**Netherlands GAAP accounting**
- Repayment of bond element.
- Neutrality of consideration for conversion option, which remains in capital reserve.

**Netherlands tax issues**
- Tax-neutral repayment of bond element.
- Consideration for conversion option remains untaxed.

**Convertible bonds – Netherlands corporate investor in convertible**

**Issue and holding of convertible**

**Netherlands GAAP accounting**
- No bifurcation of the convertible into a bond element and conversion option.
- The convertible must be accounted for at acquisition cost where it is qualified as being held for the complete duration of the convertible.
- Where the convertible cannot be qualified as being held for the complete duration of the convertible:
  - where the convertible is listed, it must be accounted for at fair market value; and
  - where the convertible is not listed, both accounting at acquisition cost and fair market value is allowed.
- In case of accounting at acquisition cost, impairments are accounted for in the profit and loss account.
- In case of accounting at fair market value, Netherlands GAAP allows value fluctuations to be accounted for in the profit and loss account either directly or at realisation by way of a revaluation reserve. Effective interest and value decreases below acquisition cost must be accounted for in the profit and loss account directly.
- Accrued interest and interest payments accounted for as income.

**Netherlands tax accounting**
- Netherlands tax accounting in principle does not correspond to Netherlands GAAP accounting but, in practice, the same principles are used.
- Bifurcation of the convertible into a bond element and conversion option.
- Accounting of the bond element at (arm’s-length) acquisition cost; in case of no or below market interest rates, recalculation of the acquisition cost of the bond element for Netherlands tax purposes based on market interest rates.
- Accrued interest and interest payments (including the difference between the acquisition cost of the bond element for Netherlands tax purposes and a higher redemption amount in case of no or below market interest rates) are generally taxable and not eligible for the participation exemption.
- Valuation of the bond element at each balance sheet date pursuant to the lower of acquisition cost or fair market value in case of value reductions of the bond.
- Accounting of the conversion option at fair market value for Netherlands tax purposes.
- Fluctuations in the value of the conversion option are in principle taxable (or deductible), but may qualify for the participation exemption insofar the equity upon conversion of the bond would qualify for the participation exemption.

**Conversion at maturity**

**Netherlands GAAP accounting**

- Accounting of the new shares at fair market value.
- No further capital gains are made for accounting purposes in case the convertible bond was accounted for at fair market value.
- Capital gains are recognised for accounting purposes in case the convertible bond was accounted for at acquisition cost, and are accounted for in the profit and loss account.

**Netherlands tax issues**

- Accounting of the new shares at fair market value.
- Potential taxable gain amounting to the difference between the book value of the bond element and the fair market value of the bond element (no rollover) unless the conversion results in a participation that qualifies for the participation exemption, in which case this potential gain remains untaxed.

**No conversion at maturity**

**Netherlands GAAP accounting**

- Repayment of the bond.

**Netherlands tax issues**

- Tax-neutral repayment of bond element.
- Tax deductible write-off of the conversion option, unless the conversion would have resulted in a participation that qualifies for the participation exemption, in which case this write-off is not deductible.
Spain

Convertible bonds\textsuperscript{22} – Spanish resident issuer

Issue of convertibles (including mandatory convertibles)

Spanish GAAP accounting\textsuperscript{23}

- Usually shareholder resolution on contingent capital (alternatively acquisition of treasury stock).
- Bifurcation of the instrument into (i) a liability element (the bond element); and (ii) an equity element (the conversion option) upon initial recognition of the instrument and not subsequently revised:
  - bond element is recognised as liability at its fair value, which is the present value of cashflow under the instrument (including coupon and, when not mandatory, redemption payments) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cashflow but with no conversion option; and
  - the equity component is recognised as equity (under the classification ‘other equity elements’) at its fair value, which is the difference between the fair value of the whole instrument (price received) and the fair value of the bond element.
- The equity element will not be re-measured.
- The bond element will be subsequently measured at amortised cost using the effective interest rate method.
- Interest accrued accounted for as interest expense.

Spanish tax issues

- Spanish tax treatment follows Spanish GAAP.
- Interest paid should generally not be subject to withholding tax on the basis that the instrument is a listed bond.
- Interest payments generally deductible for Spanish tax purposes.

Conversion at maturity

Spanish GAAP accounting

- Generally, increase of nominal share capital/share premium (alternatively, exchange of bond element against treasury stock).
- Equity element remains accounted for as equity.

\textsuperscript{22} We are assuming that the equity conversion option can only be gross physically settled (a fixed number of shares delivered on conversion of the bond).

\textsuperscript{23} Spanish GAAP accounting has recently been modified to adapt to International Standards and there is not much guidance on the interpretation of some of its rules (which are of a very general nature). In this regard, for this exercise we have interpreted Spanish GAAP on convertibles in line with IAS guidance. However please note that (as recently confirmed (June 2008) by the Spanish Institute of Accounting and Accounts Auditing) the interpretation of Spanish GAAP according to IAS is not mandatory, and therefore we cannot exclude that the Spanish accounting regulator takes a different approach.
Spanish tax issues
- No gain or loss is recognised on conversion irrespective of the fact that shares are delivered through an increase of the nominal share capital or through the acquisition of treasury shares.
- Equity component tax neutral.
- One per cent Spanish capital tax on the share capital increase (plus any share premium attached).

No conversion at maturity

Spanish GAAP accounting
- Repayment of bond element.
- Equity element remains accounted for as equity.

Spanish tax issues
- Tax-neutral repayment of bond element.
- Tax neutrality for the equity element.
- Convertibles-regulatory capital treatment.

Bond component
- Bond component of convertible bonds directly issued by a Spanish bank would not qualify as Tier 1 for Spanish regulatory capital purposes. Only the following items would be considered as Tier 1:
  - issued shares of the bank (including non-voting shares, but subject to certain limitations);
  - reserves (excluding certain exemptions);
  - certain preferred shares issued under certain requirements; and
  - minority interest may also be considered as Tier 1 capital, but with a limit of 10 per cent of the total amount of the equity of the group or sub-group.
- Nonetheless, the convertible bonds could qualify as Tier 2 or Tier 3, if they have a subordinated nature (if they rank junior vis-à-vis any common creditors of the bank) and comply with certain requirements in relation to their term. In particular, the convertible bonds could qualify:
  - as Upper Tier 2, if the expiry of the bonds is undetermined (even though the Bank of Spain may authorise the issuer to repay the bonds after five years);
  - as Lower Tier 2, if the expiry of the bonds is equal or higher than five years from the issuance; or
  - as Tier 3, if the term is equal to or higher than two years, but lower than five.

Equity component
- Although the equity element is not classified as a ‘reserve’ for accounting purposes but as ‘other equity elements’ (and thus it would literally not fit within the list of items qualifying as Tier 1) we
understand that it should be a ‘qualifying’ item for Tier 1 purposes. In fact, the fact that the equity element is part of the issuer’s own resources (as in the case of reserves) should serve as an argument to conclude that it does qualify as Tier 1.

According to Spanish GAAP, upon conversion the equity component is reclassified as share premium, which also qualifies as Tier 1.

Convertible bonds – Spanish corporate investor in convertible

Holding of convertibles (including mandatory convertibles)

Spanish GAAP

1. Bifurcation of the instrument into (i) a debt contract (bond element) and (ii) the embedded derivative (conversion option) which is not closely related to the host debt contract:
   - bond element is recognised as a financial asset at its fair value which should be the present value of the cashflow under the instrument (including coupon and, when not mandatory, redemption payments) discounted at the market rate of interest that would have been applied to an instrument of comparable credit quality with substantially the same cashflow but with no conversion option; and
   - embedded derivative recognised as a financial asset at its fair value, which is the difference between the fair value of the whole instrument (price paid) and the fair value of the bond element.

2. Measurement of the bond element depends on its classification upon recognition:
   - held-to-maturity investments are measured at amortised cost using the ‘effective interest method’; and
   - held for trading assets are measured at fair value.

3. Measurement of the embedded derivative at mark-to-market, any changes in the derivative instrument’s fair market value would be recognised in its financial statements through the profit and loss account.

4. Accrued interest accounted for as income.

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24 We are assuming that the equity conversion option can only be gross physically settled (a fixed number of shares delivered on conversion of the bond).

25 Spanish GAAP accounting has recently been modified to adapt to International Standards and there is not much guidance of the interpretation of some of its rules (which are of a very general nature). In this regard, for this exercise we have interpreted Spanish GAAP on convertibles in line with IAS guidance. However please note that (as recently confirmed (June 2008) by the Spanish Institute of Accounting and Accounts Auditing) the interpretation of Spanish GAAP according to IAS is not mandatory, and therefore we cannot exclude that the Spanish accounting regulator takes a different approach.
Spanish tax treatment

- Spanish tax treatment follows Spanish GAAP:
  - profits/losses recognised in profit and loss due to the mark-to-market of the embedded derivative shall be taxable/deductible under Spanish CIT Act; and
  - interest accrued under the bond element and recognised in profit and loss would be taxable.
- Interest received under the instrument should generally not be subject to withholding tax (if the issuer is a Spanish resident company) on the basis that the instrument is a listed bond.

Conversion at maturity

Spanish GAAP accounting

- Exercise of conversion option leads to acquisition of new shares.
- Accounting of the new shares at their fair value.
- Any gain or loss (on the difference between fair value of the shares and the book value of the bond element) would have been previously recognised under the embedded option on a mark-to-market basis and therefore no gain/loss should arise on conversion.

Spanish tax issues

- Spanish tax treatment follows Spanish GAAP.
- Exchange of bond element against new shares.
- Any taxable gain would have been previously recognised under the embedded option on a mark-to-market basis.

No conversion at maturity

Spanish GAAP accounting

- Repayment of the bond.

Spanish tax issues

- Spanish tax treatment follows Spanish GAAP.
- Tax-neutral repayment of bond element.
UK

Convertible bonds – UK resident issuer

Issue

UK GAAP accounting

- Bifurcate into a loan liability and an embedded derivative, provided:
  - the economic characteristics and risk of the embedded derivative are not closely related to those of the loan liability;
  - a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
  - the convertible (the combined instrument) is not itself fairly valued in the issuer's accounts.
- Treatment depends on whether the embedded derivative is regarded as an 'equity instrument' or a 'derivative financial instrument'.

Equity instrument

- Identify the amount of the loan liability (the host contract) by deriving its fair value based on projected cashflow and using a discount rate of an equivalent financial liability that does not include the embedded derivative.
- The difference between the fair value of the convertible as a whole and the fair value of the loan liability is the fair value of the equity component.
- The loan liability would be 'developed' in accordance with an amortised cost basis of accounting; the equity component would not be re-measured.

Derivative financial instrument

- Identify the fair value of the (embedded) derivative financial instrument (in other words, start with the 'embedded derivative' rather than the host contract).
- The difference between this fair value and the overall fair value of the convertible would be the fair value of the host contract.
- The host contract would be developed on an amortised cost basis, and the derivative would be re-measured at fair value with changes in each case going through the profit and loss account.

UK tax treatment

- Bifurcate the convertible in line with the accounting treatment.
- The credits and debits taken to the profit and loss (P&L) account reflecting profits and losses on the loan liability are taken into account for tax purposes as income items; the interest charge shown in the accounts should be deductible for tax.
- Deduction for interest may be restricted unless the convertible is listed on a recognised stock exchange or its terms are reasonably comparable to listed bonds.
If the embedded derivative is accounted for as an ‘equity instrument’: no amounts in respect of the embedded derivative should be brought into account for tax purposes.

If the embedded derivative is accounted for as a ‘derivative financial instrument’: fair value movements in the derivative are ignored for tax purposes provided certain conditions are met. These conditions would usually be met in the case of typical convertibles – issuer must not be a bank/securities trader, the underlying subject matter must be shares and the issuer must not be an entity exempt from tax on capital gains.

Prima facie there is withholding tax on interest paid if the bonds have a term of more than one year. However, there are a number of exemptions (if the bond is listed on a recognised stock exchange, or if the investor is within the scope of UK corporation tax) and there may also be treaty protection.

The issuer group will need to consider whether the issue of the convertible bonds causes the issuer company to be de-grouped – convertible bonds may be treated as equity for the purposes of the UK rules for determining whether companies are part of a group for tax purposes.

It should be possible to avoid UK stamp duty and Stamp Duty Reserve Tax provided care is taken over the form and the manner in which the bonds are issued, held and transferred.

Conversion

UK GAAP accounting

- On conversion, the loan liability would be derecognised and transferred to equity with no gain or loss recognised.
- In the case where the embedded derivative is accounted for as a derivative financial instrument, the loan liability and the derivative would be derecognised, with the (aggregate) amount being transferred to share capital (in the case of a convertible) or credited in respect of the shares delivered (in the case of an exchangeable).

UK tax treatment

- In the case where the embedded derivative is accounted for as an equity instrument, conversion should not give rise to any further taxable credit or debits.
- In the case of an embedded derivative financial instrument, different rules apply for a UK convertible and an exchangeable. If the issuer company issues its own shares (a convertible), this should be a nothing for tax purposes. If the issuer company transfers shares in another company (an exchangeable), the issuer may be subject to tax on capital gains – for the purposes of determining any gain, the initial carrying value of the embedded derivative is treated as additional proceeds for the disposal of the shares.
Cash settlement/redemption

UK GAAP accounting
- If the embedded derivative is treated as an equity instrument: on cash settlement or redemption (the former may rarely be the case since generally cash settlement features would lead to non-equity treatment), the loan liability would be debited and cash would be credited. The equity instrument would be derecognised (debited) and any balancing entry taken through P&L.
- If the embedded derivative is treated as a derivative financial instrument: on cash settlement or redemption, the derivative and loan liability would be derecognised and cash would be credited.

UK tax treatment
- If equity instrument treatment the issuer may, if certain conditions are met, get a capital loss (but not a gain) if the part of the cash payment made which is attributable to the embedded derivative exceeds the initial carrying value of the equity instrument.
- In the case of an embedded derivative financial instrument, the issuer may have a capital gain/loss if the payment attributable to the derivative exceeds/is less than the initial carrying value of the derivative.

Convertible bonds – UK corporate investor (not a financial trader)

Issue and holding of convertible

UK GAAP accounting
- Bifurcate the convertible into a loan asset and an embedded derivative contract (an option over the underlying shares).
- The initial carrying value of the embedded derivative will be its fair value. Subsequent changes in the fair value of the derivative are then recognised in the P&L.
- The difference between the initial fair value of the derivative and the overall fair value of the convertible bond will be the initial carrying value of the loan asset. Amortised cost basis of accounting is likely to be used for the loan asset (if treated as a held to maturity asset).

UK tax treatment
- Bifurcate the convertible in line with the accounting treatment.
- The credits and debits taken to the P&L reflecting profits and losses on the loan asset (following the amortised cost basis of accounting) are taken into account for tax purposes as income items.
- Provided certain conditions are met, the fair value movements in respect of the embedded derivative should be brought into account as a capital gain/loss (not income). The conditions should apply for typical convertible bonds. Income treatment would apply if the conditions are not met.
It should be possible to avoid any UK stamp duty and Stamp Duty Reserve Tax in connection with the acquisition of the bonds, provided care is taken over the form and manner in which the bonds are issued, held and transferred.

**Conversion (assuming bifurcation is required, as would usually be the case)**

**UK GAAP accounting**
- On conversion, the bond and the derivative contract would be derecognised and replaced by an investment in the shares acquired at a value equal to the aggregate carrying value of the loan asset and derivative.

**UK tax treatment**
- The investor should be treated as acquiring the shares for capital gains purposes for an amount equal to the price originally paid for the convertible bond and to have acquired the shares when it acquired the convertible bond.
- The investor’s cost basis in the shares which may be deducted in computing future gains is adjusted to reflect (i) any fair value gains or losses in respect of the embedded derivative, and (ii) any movements in the carrying value of the loan asset, which have already been brought into account for tax.
- A different treatment may apply if the bond is convertible into shares in another company (an exchangeable, rather than a convertible).

**Redemption**

**UK GAAP accounting**
- Repayment of the loan asset; termination/settlement of the embedded derivative.

**UK tax treatment**
- Disposal of an asset for capital gains purposes. As with the conversion case, the investors’ deductible cost basis is adjusted for gains or losses on the embedded derivative or movements in the carrying value of the loan asset, already brought into account for tax in respect of the embedded derivative.
US

Convertible bonds – US tax treatment of US issuer

Issuing convertible bonds

Bonds convertible at holder’s option

- The bonds generally are not bifurcated into a bond element and conversion option.
- Interest and original issue discount generally are deductible.
- Payments to non-US holders are subject to withholding tax unless the portfolio interest exemption or a treaty exemption applies.
- The portfolio interest exemption is not available if the holder would own as much as 10 per cent of the issuer upon conversion.
- Otherwise non-taxable share dividends to shareholders may be taxable unless the bond provides for an anti-dilution adjustment to the conversion price.

Mandatorily convertible bonds

- Mandatorily convertible bonds may be classified as equity for US tax purposes unless carefully structured.
- Even if mandatorily convertible bonds are debt for tax purposes, interest payable in equity upon conversion generally is not deductible.
- Units consisting of a bond and a forward share purchase contract are the typical substitute for mandatorily convertible bonds.
  - The bond, which matures after the forward purchase date, secures the share purchase obligation.
  - The holder can substitute collateral, and the bond can be remarketed to raise the share purchase price.
  - The unit price is allocated between the bond and the forward contract in proportion to their relative fair market values, which may give rise to original issue discount on the bond.
- Interest and original issue discount accruals on the bond generally are deductible.
- Payments to non-US holders are subject to withholding tax unless the portfolio interest exemption or a treaty exemption applies.

Conversion at maturity

Bonds convertible at holder’s option

- Conversion is a non-taxable exchange of debt for shares.
- The issuer recognises no gain or loss.
Mandatorily convertible bond

- If bond alone, conversion is a non-taxable exchange of debt for shares.
- If unit of a bond and a forward share purchase contract, the sale of shares for cash (typically from remarketing of the bond) is not taxable.

No conversion at maturity

- No gain, loss or deduction on retirement of a convertible bond.

Convertible bonds – US tax treatment of US corporate holder

Holding convertible bonds

Bonds convertible at holder’s option

- The bonds generally are not bifurcated into a bond element and conversion option.
- Accrued interest and original issue discount are taxable.
- Any premium paid for the bond is allocated between the bond element and conversion option in proportion to their fair market values for purposes of calculating bond premium.

Mandatorily convertible bonds

- Mandatorily convertible bonds may be classified as equity for US tax purposes unless carefully structured.
- Units consisting of a bond and a forward share purchase contract are the typical substitute for mandatorily convertible bonds.
  - The bond, which matures after the forward purchase date, secures the share purchase obligation.
  - The holder can substitute collateral, and the bond can be remarshaled to raise the share purchase price.
  - The unit price is allocated between the bond and the forward contract in proportion to their relative fair market values, which may give rise to accruable original issue discount on the bond.
- Accrued interest and original issue discount accruals on the bond are taxable.

Conversion at maturity

Bonds convertible at holder’s option

- The holder generally recognises no gain or loss on conversion.
- Any market discount on the bond that the holder has not elected to accrue while it held the bond is taken into income.
- The holder’s basis in the bond carries over to the shares.
Mandatorily convertible bonds

- If bond alone, conversion is treated the same as conversion of a bond convertible at the holder's option.
- If unit of a bond and a forward share purchase contract, the holder typically has gain or loss on remarketing of the bond and then treats acquisition of the shares as a cash purchase.

No conversion at maturity

- The holder may have gain or loss on repayment of a bond acquired for an amount other than the face amount.
- Any market discount that the holder previously has not recognised is taken into income.
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Capital markets

Our capital markets practice is at the forefront of the market for innovation and range of transactions. The strength of our international team of more than 200 dedicated capital markets practitioners enables us to lead technical and market developments. We advise on the full spectrum of capital markets transactions, including convertible and other equity-linked offerings as well as equity capital markets (ECM) transactions (both primary and secondary offerings), debt issuance products, including high-yield, regulatory capital and other hybrid offerings, liability management transactions and asset-backed securities issues.

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