THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2025

MODULE 3.05 – BANKING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The cost of the bank borrowing will vary with changes in interest rate. The swap contract is a hedging contract. There is a hedging relationship between the hedged item (the interest rate swap). The purpose is to reduce earnings volatility arising from accounting mismatches between the hedged item and the hedging instrument. For accounting purposes hedging contracts are classified as fair value hedges, cash hedges and net investment hedges. This is a cash hedge, because it is designed to counteract the changes in cash outflow caused by changes in interest rate.

In cash terms the swap contract will have the effect of substituting a fixed annual finance charge of 4% for the variable interest rate charge. However, for accounting purposes Real Estate will be required to recognise changes in fair value of the hedging contract as a separate component of equity and recycle these changes to the income statement. This is because recognition of profits and losses on derivative contracts cannot as a rule be deferred.

For UK tax purposes Real Estate can elect to defer recognition of the fair value profits and losses until the item to which they relate is disposed of. This is under the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Gains and Losses) Regulations 2014, reg 9. This removes the accounting mismatch for tax purposes.

Part 2

Years 1–4:
Net rental profit (after loan plus swap) = £500,000 per year.

Year 5:
Net recurring rental profit = £500,000
Plus £10 million gain on property disposal = £10,500,000
Minus £10 million swap break cost = £500,000 net profit

For both accounting and tax purposes, Real Estate plc's income will therefore be:

Year 1: £500,000
Year 2: £500,000
Year 3: £500,000
Year 4: £500,000
Year 5: £500,000

Although in year 5 there is a £10 million gain on property disposal, this is offset by the £10 million swap breakage payment, leaving the same £500,000 net income.

Part 3

On the sale of the property Real Estate makes a capital gain of £10m. However, the breakage payment is treated as a loss for capital gains tax purposes of £10 million: TCGA 1992, s 143. Accordingly, on the sale there is no taxable profit.

Question 2

Part 1

The purpose of the convertible bond for the issuer is to conserve cash by paying no interest or a reduced rate of interest on its borrowings while a project proceeds and produces only cash outflows, by offering the investor an equity kicker whose value exceeds the interest foregone. The investor assumes that the increase in the value of the shares in the future will exceed the amount of interest which he could have obtained on conventional debt.

Part 2

UK Homes must adopt bifurcation, i.e. divide the amount raised (£10 million) into two parts, one a notional loan relationship and the other a payment for the share option. If the split were 85/15, UK Homes would account for £85m as a liability, and 15 as a contribution to equity, which would be recorded in OCI.

Part 3

Corporate investors can adopt either a bifurcation treatment, in which case it recognises the debt element at amortised cost, and recognises changes in the value of the share option at fair value. Or it can treat the instrument as a single instrument, and account for the convertible bonds at fair value.

Part 4

While discharge of the bond is outstanding, UK Homes should compute the interest cost using the effective interest rate method, and accrete the instrument from 85 to 100 at the end of Year 3.

Part 5

If the investor adopts a bifurcation treatment, he will also accrete the bond to its nominal value and include the annual increase as finance income, and recognises changes in the value of the share option at fair value as an annual profit or loss.

PART B

Question 3

Part 1

The Mingrelian Commercial Bank is not carrying on the business of drilling and oil extraction, so the payments it receives per barrel of oil are not profits of a trade of oil extraction. The receipts could be regarded as profits of a trade of banking, but as there is no repayment required for the loan, part of the receipts must be a repayment of capital, the rest being a substitute for interest. The receipts are not profits of a deemed property trade in the ordinary sense, but that may depend on the definition of real property in the double taxation agreement. The residual category is royalties.

Part 2

The advance was made by the head office of the Mingrelian Commercial Bank, not the UK PE. If banking profits or royalites, the receipts are likely to be taxable in Mingrelia.

Part 3

The functional currency of the Mingrelian Commercial Bank is non-sterling. The profits for corporation tax should be computed in the functional currency, and then converted into sterling at the appropriate exchange rate, which is either the average rate of exchange for the period of account, or the spot rate at the end of the period of account: CTA 2010, s 7.

Question 4

Part 1

Capital adequacy is capital/RWA x 100. The Tier 1 capital is 5% of RWA: (10m/200m) x 100 = 5%. Therefore the bank does not have sufficient Tier 1 capital.

Part 2

Loans to central banks have a risk weighting of 0%. Accordingly, capital would increase by £15m, but there would be no increase in RWA. The Tier 1 ratio is therefore (25m /200m) x 100 = 12.5%. Therefore the bank satisfies the Tier 1 ratio.

Part 3

Public companies are prohibited from providing financial assistance for the purchase of their own shares, because this would increase the value of the shares without increasing the company's assets, Accordingly, this transaction would appear to be illegal.

PART C

Question 5

The predominant method adopted to stabilise banks was to recapitalise the banks by the issue of new shares to governments which therefore became the owners or part owners of affected banks.

Another method adopted was quantitative easing, whereby central banks bought up government securities held by banks and insurance companies. These are all documented in Adam Tooze, *Crashed*.

Question 6

This has been advocated, in particular by the present United States administration. A central bank is a lender of last resort in a financial system, and its liabilities are backed by the entire tax revenues of the state. It pays tax in the same way as a commercial bank. Reserves give the central bank a measure of independence.

Cryptocurrency comprises a significant proportion of financial assets held by individuals and investors. That may qualify them for central bank reserves. However, they do not have any form of backing, in terms of economic performance or an issuing entity. Their values are extremely volatile. They are also prone to fraud on investors and use for illicit purposes.

For tax purposes gains and losses on cryptoassets are not recognised on a fair value basis, but treated as capital gains and losses, though recognition of losses can be accelerated. This leads to tax volatility. These factors point against their use for central bank reserves.

Question 7

ALP-based transfer pricing is used to construct an artificial value on transactions between related parties based in different jurisdictions, where the actual values used in transactions may have a distortive effect, by transferring value generated in one jurisdiction to another jurisdiction. These are normative values.

Tariffs imposed on goods or services emanating from another jurisdiction are calculated by reference to transaction values, i.e. the actual values used. In the case of goods this would be difficult to reconcile with the use of normative values for other tax purposes. Tariffs are, however, difficult to impose on services, which are the main current area of application of ALP-transfer pricing.

Question 8

Part 1

Companies make share buybacks to improve the rate of return on capital for remaining shareholders and to pay a special dividend to selling shareholders.

Part 2

The effect of a fully accepted buyback on the Bank's equity will be:

Item	Before	Change	After
Share capital	2,000,000	(50,000)	1,950,000
Share premium	4,000,000	(350,000)	3,650,000
Reserves	8,000,000	(100,000)	7.900,000
	14,000,000	(500,000)	13,500,000

Part 3

Mr Jones will receive cash of 10,000. 1,000 + 3,000 is return of capital. The balance of 6,000 is dividend. This is taxed at 33.75%. 33.75% x 6,000 = 2025. His after tax receipt is £7,975.

Part 4

The Bank's capital adequacy ratio post-transaction is 13,500,000/95,000,000 x 100 = 14.2%. So the Bank risks falling below its required capital adequacy ratio.