FIELD COURT TAX CHAMBERS

FCTC DIGEST

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CONTENTS

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EDITORIAL

Patrick Soares

Welcome to all our readers to the 17th Edition of the FCTC Digest.

There is always a certain dread when practitioners are asked to confirm that **SDLT group relief** is available on transfers between companies because the relief is full of technicalities, anti-avoidance provisions, traps and HMRC practices. If one keeps a steady nerve these can be overcome. The **first article** sets out the editor's checklist with some common examples. Hopefully the article will take away some of the dread.

The **second article** is by **Patrick Way KC**. This deals with the recent case in the Upper Tribunal – *HMRC v A taxpayer* [2023] UKUT 00182 (TCC) – which sets out the parameters of the **"exceptional circumstance"** relief under which days in the UK can be ignored when applying the **statutory residence test** (SRT) UK day count. Patrick Way refers to the test adopted by the Upper Tribunal as

being **"very tough indeed."** In particular, days in the United Kingdom are excluded only if the individual is in the United Kingdom in the first place and then prevented from leaving. If the individual comes to the United Kingdom in an emergency that will not do because the "prevention" requirement in the legislation is not satisfied. Hopefully the case will go to the Court of Appeal and that distinction will not be drawn.

The **third article** is by **Peter Vaines** and it deals with the recent practice statement by HMRC on what represents a repayment under the **loans to participator provisions** within CTA 2010 s455. HMRC point to "an increasing number of cases" where repayments of loans and overdrawn directors' loan accounts are said to have been repaid but all that has happened is that debtor balances have been moved around a series of associated companies. Two points to note generally on these provisions is they do not apply to loans from overseas companies and the only – the one and only – win which the taxpayer has had before the GAAR panel related to a refinanced participator loan.

The **fourth article** is by **Dilpreet Dhanoa** and deals with the tricky subject of being able to

introduce new evidence before an appellate court or tribunal. The general belief is it is difficult to introduce new evidence. Dilpreet looks at the guidance in this area and the "exception gateways" which the taxpayer must squeeze himself or herself into.

The **fifth article** is on **ESG-Linked structured products** by **Oktavia Weidmann**. She introduced the readers to ESG derivatives in the 15th FCTC Digest.[1] In this follow-up article, Oktavia goes further into ESG-linked structured products and looks into the related regulatory, accounting and taxation questions. As a rule of thumb, the author proposes that it is decisive for the taxation of ESG-linked structured products to determine what in substance has been created and what category of instrument it falls into.

The **sixth and final article** is also by **Oktavia Weidmann** and she looks at the economic properties and accountancy practices and taxation provisions applicable to **crypto structured products**. The accounting and taxation of crypto

[1] Oktavia Weidmann, ESG derivatives, the legal and economic design of ESG derivatives and their regulatory, accounting and tax treatment part 1, 15th FCTC Digest, 160-186.

structured products are far from certain as they have been around only for two years. The author believes that as soon as those structured products become more mainstream, investors and their accountings and tax advisors will have to think about how to account and tax those instruments. Oktavia warns: the article is a first step to raise awareness of what may come our way in the future, and be prepared.

Patrick C Soares

FCTC

GROUP RELIEF AND SDLT - COMMON TRANSACTIONS AND THINGS TO LOOK OUT FOR

Patrick C Soares

INTRODUCTION

SDLT is not payable on intra-group land transactions.

The SDLT exemption is contained in FA 2003 Sch 7.

The exemption still strikes fear in the hearts of practitioners because the exemption is full of technicalities, anti-avoidance provisions, traps and HMRC practices.

CHECK LIST

Ten conditions must be considered.

Condition 1 Shares and Equity Holders – 75% requirement

The companies must be grouped for SDLT purposes in terms of ordinary share capital and *equity holders* (FA 2003 Sch 7 para 1).

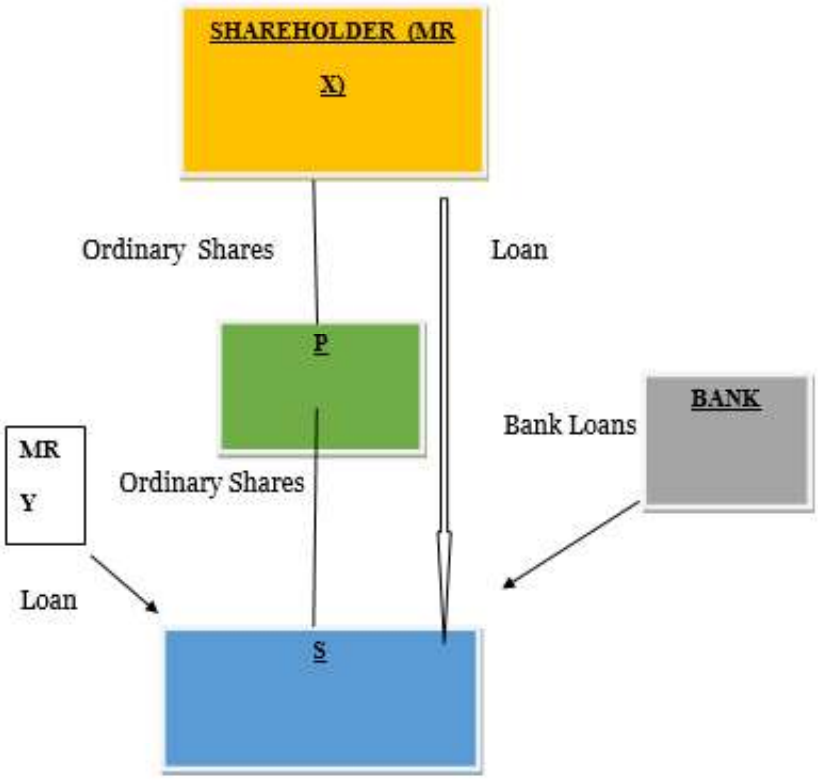
For the purposes of group relief a company ("company A") is the 75% subsidiary of another company ("company B") if company B—

(a) is beneficial owner of not less than 75% of the **ordinary share capital** of company A,

(b) is beneficially entitled to not less than 75% of any **profits available for distribution** to **equity holders** of company A, and

(c) would be beneficially entitled to not less than 75% of **any assets of company A available for distribution** to its **equity holders** on a winding-up.

An equity holder would not include a bank which lends on normal commercial terms or a person who makes an interest free repayable on demand loan to the company with no rights to convert the loan to shares.



NOTES ON THE DIAGRAM CONCERNING CONDITION 1.

1. The indirect shareholder loan to S from Mr X is interest free repayable on demand with no rights of conversion; the shareholder is thus not an equity holder in S by virtue of that loan.

2. The Mr Y loan is interest free repayable on demand with no rights of conversion; Mr Y is thus

not an equity holder by virtue of that loan.

3. The bank charges a commercial rate of interest on a normal bank loan and it is not an equity holder by virtue of that loan.

4. The above means the only relevant equity holder in S is P and P and S are grouped for SDLT purposes.

Condition 2 Loss of control

There must be no arrangement in existence for a third party to control the purchaser but not the vendor (Sch 7 para 2(1)).

HMRC state:

> STAMP DUTY LAND TAX: GROUP RELIEF
>
> April 2004. Inland Revenue Tax Bulletin—Issue 70 (Extract)
>
> .....24. The Inland Revenue will not argue that paragraph 2(1) denies group relief in cases where the transferor (S) is to leave the group having transferred the land to other group members (P).

Condition 3 Arrangements for purchaser to leave the group

There must not be an arrangement in existence for the *purchaser* to leave the group (Sch 7para 2(2)(b)).

One may argue the purchaser also leaves the group (on a sale by S to P followed by the liquidation of S) as there is no group left if the only remaining company is P but the editor has never known HMRC to take that point. Some taxpayers do create a new subsidiary or only liquidate the vendor subsidiary after 3 years but that does not seem necessary in practice.

Condition 4 Consideration

No part of the purchase consideration must come from a third party (Sch 7 para 2(2)).

The HMRC guidance shows that normal external loans will not create a problem (HMRC Tax Bulletin Issue 70).

Accordingly, the restriction is not applicable to conventional borrowing arrangements. This part of the legislation seems to be all bark and no bite.

Condition 5 Tax avoidance

27. The transactions must not be part of an arrangement to avoid tax (Sch 7 para 2(4A) and SDLTM23040).

In SDLT Guidance SDLT group relief 7/8/2013 it is provided thus:

> To promote greater certainty in HMRC Stamp Taxes approach in the application of FA 2003 Schedule 7 paragraph 2(4A)(b), HMRC Stamp Taxes confirmed the following, with the warning that the presence of steps in addition to those described below may indicate, when taken together, that there are arrangements of which the main purpose or one of the main purposes is avoidance of tax:
>
> A business may choose to acquire a property-owning company as opposed to acquiring the property from that company. The purchaser may, after acquiring the company, transfer the property out of the company acquired and

into a different company in the purchasing group. HMRC do not regard that of itself, and subject to the list of transactions mentioned above, as resulting in the avoidance of tax such that FA 2003 paragraph 2(4A)(b) would be in point, even if the acquisition of the property-owning company and the subsequent intra-group transfer of the property formed part of the same arrangements.

The purchaser may, after acquiring the company and transferring the property intra-group, liquidate, wind-up or strike-off the company acquired. HMRC do not regard that of itself as resulting in, or being evidence of, the avoidance of tax such that FA 2003 paragraph 2(4A)(b) would be in point, even if the liquidation, winding-up or striking-off formed part of the same arrangements that also included the acquisition and the intra-group transfer.

Condition 6 Withdrawal of the relief because purchaser leaves the group

28. If within 3 years of the land transfer the transferor (subsidiary) ceases to be grouped with its parent the relief is withdrawn (Sch 7 para 3). However FA 2003 Sch 7 para 4(4) states that if the subsidiary-transferor leaves the group by being wound up the relief is not withdrawn.

Condition 7 Withdrawal of relief through disposal of the vendor

The general rule is there is no withdrawal of the relief if the group is broken because the subsidiary leaves the group. However if the control of the parent purchaser changes within 3 years the relief is withdrawn (FA 2003 Sch 7 para 4ZA).

Assume S sells the land to P and S is liquidated.

FA 2003 Sch 7 para 4ZA(4) provides that if there is a change of control of the purchaser (P) within 3 years of the land transfer from S to P and S leaves the group as a result of a transaction relating to securities in S, the group is treated as having ceased and SDLT is payable.

This provision is widely worded. It covers a transfer from a subsidiary to a parent where control of the parent changes within 3 years and overlaps with FA 2003 Sch 7 para 4(4) or at least they cover similar ground.

The question is whether the group relief is lost if the owner of P sells P within 3 years of the land transfers (from S to P) as the sale will mean there will be a change of control of P.

The first argument (against a charge arising) is FA Sch 7 para 4(4) provides that a liquidation of the subsidiary vendor does not give rise to a clawback of the relief because para 4ZA(4) is subject to para 4(4): HMRC accept that in a liquidation para 4ZA(4) will not "normally" apply. See SDLT: GROUP RELIEF - PARA 4ZA 26/11/2008 HMRC Guidance).

The second argument is when one liquidates a company (S) there is no transaction relating to shares. In IRC v Joiner 50 TC 449, Viscount Dilhorne at 483 stated:

> Nor, although a liquidation of a company involves the distribution of surplus assets

> to shareholders, would one, I think, normally describe the liquidation of a company as constituting of itself a transaction relating to securities

If the transferor subsidiary is sold rather being liquidated (perhaps because it owned other valuable property) then the control of P should not be changed within 3 years: if there must be such a change practitioners must refer to the HMRC guidance.

Condition 8 The GAAR and DOTAS

These need to be considered but will have no application to normal group transactions.

Condition 9 FA 2003 s75A

This must be considered but will have little relevance to normal group transactions

Condition 10 Ramsay

The Ramsay approach to statutory interpretation must be considered in appropriate cases but will have little relevance to normal group transactions

COMMON TRANSACTIONS (P=PARENT COMPANY, S= SUBSIDIARY COMPANY)

S TRANSFERS THE LAND TO P AND S IS LIQUIDATED

This should not be a problem.

S OWNS GREENACRE AND REDACRE AND GREENEACRE IS TRANSFERRED TO P AND P THEN SELLS S OUT OF THE GROUP (S CONTINUES TO HOLD REDACRE)

This should not be a problem but the control of P must not change within 3 years. Note also S must not have acquired Redacre from a group member within 3 years.

P BUYS S FROM V LTD AND STRIPS THE LAND OUT OF S AND LIQUIDATES S

This should not be a problem provided S did not acquire the land within the prior 3 years from an intra-group transfer.

MR X BUYS SHARES IN A PROPERTY COMPANY FROM MR Y

This is not a problem – SDLT is not in issue on such a share purchase

MR X BUYS SHARES IN S FROM P

SDLT may be in issue if P had transferred property to S within the last 3 years.

P TRANSFERS LAND TO S AND WAITS OVER 3 YEARS BEFORE SELLING S

SDLT will not be payable.

P SETS UP 3 SUBSIDIARIES WHICH BUY PARCELS OF LAND FROM NON-GROUP MEMBERS AND THEY (THE 3 SUBSIDIARIES) ARE ALL SOLD BY P WITHIN 3 YEARS OF THE PROPERTIES BEING PURCHASED

SDLT is not in issue on the share sales.

EXCEPTIONAL CIRCUMSTANCES IN THE DAY COUNT FOR THE STATUTORY RESIDENCE TEST

HMRC v A TAXPAYER

Patrick Way KC

Speed read

In the recent case of HMRC v A Taxpayer, the Upper Tribunal has laid down its interpretation of the meaning of "exceptional circumstances" for determining when days spent in the United Kingdom may be ignored in the day count under the Statutory Residence Test. The Upper Tribunal's test is very tough indeed. In particular, days in the United Kingdom are excluded only if the individual is in the United Kingdom in the first place and then prevented from leaving. If the individual comes to the United Kingdom in an emergency that will not do because the prevention requirement is not satisfied.

So assume that an exceptional circumstance arises whilst the individual is in the United Kingdom. For example (I am guessing what might count as an

exceptional circumstance) assume that a major road crash has occurred which puts the taxpayer's spouse in grave danger. That could count as an exceptional circumstance if the taxpayer stays in the United Kingdom. By contrast, if the taxpayer is outside the United Kingdom and comes back to look after the spouse that apparently will not count.

The word "prevent" is doing some "heavy lifting".

On a separate point, as a matter of tactics, it is always worth cross-appealing a point which one has lost below as (a) one might win that point on appeal; and (b) it may make is easier to defend the point that has been won below.

Analysis

First-tier Tribunal

The case of *HMRC v A Taxpayer* ([2023] UKUT 00182 (TCC)) was heard in June 2023 and judgment was given on the 28th July 2023.

My colleague in chambers, Peter Vaines, considered the decision at first instance in the 12th Edition of the FCTC Digest (September 2022). Also, the facts relating to the appeal from the First-tier Tribunal can be found in my Tax Brief. The following analysis

aims to reduce the points to the most important aspects.

An individual taxpayer came to the United Kingdom, firstly, because she was concerned that her sister might take her life and she wanted to prevent that. And, secondly, she was concerned that her sister and the sister's minor dependent children were living in relative squalor and the taxpayer wanted to attempt to ameliorate that position (the need to look after the children).

The taxpayer argued, in the First-tier Tribunal, that both of the above scenarios amounts to exceptional circumstances for the purposes of the UK day count under the Statutory Residence Test found in the Finance Act 2013 ("FA 2013") Schedule 45.

The First-tier Tribunal decided that seeking to stop the sister from taking her life was not an exceptional circumstance. The First-tier Tribunal did, however, agree that coming to look after the children on the particular facts did amount to exceptional circumstances.

HMRC appealed in relation to the second issue but the taxpayer chose not to cross-appeal in respect of

the first issue. That seems to have been a tactical error.

Before we look at the decision of the Upper Tribunal I set out the relevant legislation which is found at FA 2013 Schedule 45, paragraph 22:

> "(1) If P is present in the UK at the end of a day, that day counts as a day spent by P in the UK.
>
> (2) But it does not do so in the following [case].
>
> ...
>
> (4) The [relevant] case is where—
>
> (a) P would not be present in the UK at the end of that day but for exceptional circumstances beyond P's control that prevent P from leaving the UK, and
>
> (b) P intends to leave the UK as soon as those circumstances permit.
>
> (5) Examples of circumstances that may be "exceptional" are—

(a) national or local emergencies such as war, civil unrest or natural disasters, and

(b) a sudden or life-threatening illness or injury.

The Upper Tribunal

The Upper Tribunal took what may reasonably be described as a harsh view.

The Upper Tribunal set out, at paragraph 125 of their decision, their suggested approach to the exceptional circumstances rule found at paragraph 22(4) as mentioned.

As this may well form the basis for the approach which practitioners should adopt I set out the Tribunal's summary of the exceptional circumstances test, as they saw it, below:-

"**22(4) requirements**

(1) Consider separately each of the days for which the taxpayer is claiming to have met the para 22(4) requirements.

(2) For each of those days:

(a) Establish the facts which the taxpayer asserts relate to each of the five elements of the statutory test, the burden being on the taxpayer, namely that:

(i) the circumstances were exceptional;

(ii) the circumstances were beyond the taxpayer's control;

(iii) the taxpayer would not have been present in the UK at the end of that day but for those circumstances;

(iv) the circumstances prevented the taxpayer from leaving the UK; and.

(v) the taxpayer intended to leave the UK as soon as those circumstances permitted.

(b) Establish the facts which the taxpayer asserts show that the circumstances changed so as to allow the taxpayer to leave the UK

after the end of the relevant day or days; this will shed light on whether the taxpayer was previously prevented from leaving by the exceptional circumstances.

(c) Consider which facts are objectively proven, either by documents or credible oral evidence, or by both.

(d) In the light of those proven facts, decide whether each of the statutory requirements has been satisfied.

The key elements, in my view, are as follows:-

(a) the Upper Tribunal took a very tough approach to the exceptional circumstances requirements which, to my way of thinking anyway produces an approach which is probably more than Parliament could have intended.

In other words the taxpayer in the situation under review was bound to lose because she was not prevented from

leaving the United Kingdom. Rather she came to the United Kingdom in circumstances which (in any event) the Upper Tribunal held were not exceptional circumstances. It may be that on a literal interpretation of the legislation (particularly the use of the word "prevent") the Upper Tribunal's approach is correct. However, when one applies a purposive approach it seems to me that the Upper Tribunal's decision falls into some doubt. A purposive approach is not one that is limited to tax avoidance. Nor are the consequences of that approach exclusively for the benefit of HMRC: they can be for the benefit of the taxpayer. In the case of *Balhousie Holdings Limited v. HMRC* (Scotland) (UKSC 2019/0103) Lord Briggs said as much. It is my view that the purpose of the exceptional circumstances rule was to exclude days from the UK day count if it would not, in effect, be fair to include them because the reason why the individual was in the United Kingdom

was pursuant to one or more exceptional circumstances.

In my view, the taxpayer in the situation under review clearly fell within that situation. I would therefore have found for the taxpayer at first instance (coming to the United Kingdom to help prevent her sister from taking her life); and also I would have found for the taxpayer in the second situation (coming to the United Kingdom to look after her sister and the minor dependent children).

However, it is plain that the current interpretation of the exceptional circumstances rule is as follows:-

(i) the taxpayer must be in the United Kingdom and prevented from leaving – the taxpayer cannot come to the United Kingdom to deal with an exceptional circumstance; and

(ii) the identification of exceptional circumstances is by reference to a very harsh test;

(b) consider the facts which are objectively proven either by documents or credible oral evidence or by both.

In the case under review the sister was criticised by the Upper Tribunal for not keeping daily records of the reasons why she was in the United Kingdom. Given that she was in the United Kingdom to prevent a suicide that seems to be an extraordinary harsh decision.

The Upper Tribunal also took a dim view of the fact that the sister (who had previously on more than one occasion threatened to take her life) did not give evidence. It seems to me that this was another harsh decision. It also might have looked odd for somebody who was a suicide risk to be prepared to go through the torment of being cross-examined. Further, in my view, the key to this case was the evidence of the taxpayer and a pejorative view should not have been taken of the sister's refusal to give evidence in the circumstances.

The difficulty of this decision therefore is that it makes it impossible for somebody to come to the United Kingdom in very dire circumstances for good reasons and claim the exceptional circumstances exception. This is because of the need to have been in the United Kingdom in the first place and to be prevented from leaving.

For example, it seems unfair to say the least that if the taxpayer had been in the United Kingdom and then had decided to stay on for six days to prevent her sister from taking her life (had that been an exceptional circumstance which, unfortunately, the First-tier Tribunal decided was not the case) that event could have been an exceptional circumstance because the taxpayer was already in the United Kingdom and prevented from leaving. By contrast, coming to the United Kingdom in precisely the same situation (to prevent her sister taking her own life – assuming there was an exceptional circumstance) was not exceptional because the taxpayer would not have been prevented from leaving.

The decision of the Upper Tribunal simply seems wrong to me. The purpose of the exception in my view is to ensure that the day count works fairly and

that the days are not artificially inflated by an emergency. The Upper Tribunal decision stops that from applying and, to be fair, may do so by reference to a literal interpretation of the legislation. I hope that the Court of Appeal will give a more humane decision assuming leave to appeal to the Court of Appeal is applied for and obtained.

Procedure – always cross-appeal if you can

I now turn to a lesser point which is the question of procedure. As it turns out, the decision not to cross-appeal (with the benefit of hindsight) was a potential error of judgment. I say this because it allowed HMRC's barrister to contrast the two issues at stake and to "make mischief out of the position". What he said was that "logically speaking", if the First-tier Tribunal considered that taking one's life was not an exceptional circumstance then it must follow that the "apparently lesser situation" of making the sister's home a place of safety could not conceivably have been an exceptional circumstance either. In other words, the entirety of the First-tier Tribunal's decision was illogical and open to challenge.

When it comes to dealing with matters of procedure (and generally) I am a fully paid up member of the "There but for the grace of God go I" club. However, by not cross-appealing the first issue (the potential suicide risk) it made it much more difficult to defend the second situation involving caring for the minor dependent children and needed a place of safety and appropriate care for the children. In other words, by not cross-appealing the taxpayer was "on the back foot" and at a disadvantage in the Upper Tribunal.

Conclusion

It is hoped that this case will go to the Court of Appeal and that a more kind-hearted decision will be reached as to the meaning of "exceptional circumstances". Also, perhaps the word "prevent" can be given a less literal meaning. As mentioned in this article, it seems irrational that staying in the United Kingdom to deal with an exceptional circumstance is all right; but coming to the United Kingdom to deal with an identical exceptional circumstance is not.

LOANS TO PARTICIPATORS

Peter Vaines

To help us pass the time during lockdown, HMRC issued some interesting guidance on the rules relating to repayments where there have been loans to participators within the terms of section 455 CTA 2010. It was not guidance really but an explanation of their view about what represents repayment.

Everybody knows about the tax implications of loans by a close company to participators and their associates. They are often referred to as loans to directors; and of course directors are often participators – but not always. If a company makes a loan to a participator which is outstanding for more than nine months after the end of the company's accounting period, section 455 CTA 2010 requires the company to make a payment equal to 33.75% of the loan to HMRC.

Where a liability under section 455 has arisen and has been paid by the company, the amount can be recovered from HMRC under section 458 if:

a) the loan is repaid to the company, or

b) the debt is released or written off.

HMRC point to "an increasing number of cases" where repayments of loans and overdrawn directors' loan accounts are said to have been repaid but all that has happened is that debtor balances have been moved around a series of associated companies.

HMRC say (on the authority of *Collins v Addies TC 65 190*) that:

> "the substitution of a fresh debtor (for the original debtor) does not constitute repayment."

Collins v Addies explains that debtors cannot just transfer liabilities to somebody else; liabilities have to be novated, and a novation is a tripartite contract by the debtor, the existing creditor and the new creditor. The existing debt is released and substituted by another debt owing to the new creditor. The Court held that a release of a loan by way of novation does not represent repayment.

That is all very well – but *Collins v Addies* expressly held that a novation was a *release*, so a refund under section 458 would be equally available to the company. (There would of course be a corresponding effect on

the participator who would be chargeable to income tax on the amount released by reason of section 415 - 417 ITTOIA 2005).

In their guidance, HMRC express their concern (with some justification), where repayments are said to have been effected by circular or recycling transactions.

They specifically highlight the position where a shareholder borrows £2 million from company A and just before the repayment deadline he borrows £2m from company B to repay company A. When the deadline or repayment of company B is approaching, he borrows (again) from company A to clear his debt in company B – and so on every year. On each relevant date (nine months from the end of the accounting period) the loan has been repaid and no section 455 arises.

These arrangements clearly deserve to be challenged because the reality of the situation is clear. Indeed, it is difficult to avoid thinking about Ponzi schemes where money paid out, or lost (creating a hole in the finances) is filled by new investors introducing new money. Accountants have known about this since the dawn of time (which for accountants is 1494) and called it *teeming and lading*. This is where a cash loss in one

customer's account is covered by crediting money received from another customer, and so on. Until the music stops of course.

However, the reason given by HMRC for challenging such recycling arrangements does not really stand up to scrutiny. They say:

> "looking at the legislation as a whole and its purpose there is no repayment and section 455 should apply to the amounts withdrawn from the companies".

Looking at the legislation as whole does not help. The legislation does not provide any grounds for saying that there has been no repayment. What HMRC are really saying is that the legislation does not catch such recycling arrangements – but it jolly well ought to, so we are going to say it does.

Not good enough I am afraid – as HMRC are quick to insist when a taxpayer claims a relief which looks entirely justifiable – but it does not quite satisfy the terms of the legislation.

But *Collins v Addies* is not relevant here; we are not looking at novations or releases and even if we were, it would not make any difference to the analysis. We are

looking at whether there really has been a repayment.

Obviously to be effective, the recycling arrangements must be genuine – otherwise they would fall down on any number of grounds, but it is difficult to say that a loan to company A has not genuinely been repaid if a genuine repayment has been made. And the same with company B.

Rather than relying on inapplicable authority, HMRC might do better seeking to invoke section 464A CTA 2010. This is a Targeted Anti Avoidance Rule which applies where the company or companies are party to tax avoidance arguments where one of the main purposes is to avoid or reduce a charge to tax under section 455. However, that is not a slam dunk by any means.

TO ADMIT OR NOT TO ADMIT:

SHOULD NEW EVIDENCE BE ADMITTED ON APPEAL…?

A discussion of case law concerning admission of new evidence before appellate courts and tribunals

Dilpreet K. Dhanoa

"…The trial is not a dress rehearsal. It is the first and last night of the show…"[1]

Admission of new evidence before an appellate court or tribunal is a matter which should be broached with significant caution. There must be some exceptional circumstance as to why the evidence was not produced before, and at the very least some explanation that goes towards setting out the reasons why fresh evidence is being sought to be admitted at such a late stage. This position is supported in the Civil Procedure Rules, wherein rule 52.21(2) makes clear that the default position is that an appellate

[1] *FAGE UK Ltd and another v Chobani UK Ltd and another* [2014] EWCA Civ 5, at [114] *per* Lewison LJ.

court *"will not receive…evidence which was not before the lower court."* The Tax Tribunals have their own rules of procedure and the arena of tax highlights this cautionary approach even further: after all, tax cases invariably include a public body on the one side (HMRC) and the taxpayer on the other, so the need to ensure all evidence is produced at the fact finding hearing is imperative – save for very few circumstances. As noted in *Bradshaw v Blunden*:

> "It is a well-established and salutary rule that the parties to an appeal to the Court should not, in the absence of special circumstances, be enabled to go back to the Commissioners and call fresh evidence on issues which were raised in the original proceedings and as to which they had full opportunity of calling such evidence as they might be advised."[2]

In theory, parties' proper and full opportunity to test a case and the evidence supporting or contradicting it, should be in front of the court or tribunal of first

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[2] *Bradshaw v Blunden (Inspector of Taxes) (No2)* (1960) 39 Tax Cas 73, at 80 *per* Pennycuick J citing *Murphy v Australian Machinery Investment Co., Ltd.* (1948) 30 Tax Cas 224, at 260 *per* Tucker L.J.

instance. Appellate courts primarily and often only deal with matters of law. This was made clear in the infamous case of *Edwards v Bairstow*[3] where Viscount Simmonds in the House of Lords made clear the position:

> "When the Case comes before the court, it is its duty to examine the determination having regard to its knowledge of the relevant law. If the Case contains anything ex facie which is bad law and which bears on the determination, it is, obviously, erroneous in point of law. But, without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law, and that this has been responsible for the

[3] *Edwards (Inspector of Taxes) v Bairstow and Another* [1955] 3 All ER 48.

> determination. So there, too, there has been error in point of law."[4]

Despite being determined almost 70 years ago, *Edwards v Bairstow* remains good law. In 2014, the Court of Appeal handed down guidance on the admission of new evidence at appeal stage:

> "Appellate courts have been repeatedly warned, by recent cases at the highest level, not to interfere with findings of fact by trial judges, unless compelled to do so. This applies not only to findings of primary fact, but also to the evaluation of those facts and to inferences to be drawn from them…. The reasons for this approach are many. They include:
>
> i) The expertise of a trial judge is in determining what facts are relevant to the legal issues to be decided, and what those facts are if they are disputed.
>
> ii) The trial is not a dress rehearsal. It is the first and last night of the show.

[4] *Edwards (Inspector of Taxes) v Bairstow and Another* [1955] 3 All ER 48, at 57.

> iii) Duplication of the trial judge's role on appeal is a disproportionate use of the limited resources of an appellate court, and will seldom lead to a different outcome in an individual case.
>
> iv) In making his decisions the trial judge will have regard to the whole of the sea of evidence presented to him, whereas an appellate court will only be island hopping.
>
> v) The atmosphere of the courtroom cannot, in any event, be recreated by reference to documents (including transcripts of evidence).
>
> vi) Thus even if it were possible to duplicate the role of the trial judge, it cannot in practice be done."[5]

In a tax context, this has been upheld recently in the Upper Tribunal case of *Kennedy*, wherein the Decision made clear that the test is: *"whether a tribunal's evaluative judgment was within a*

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[5] *FAGE UK Ltd and another v Chobani UK Ltd and another* [2014] EWCA Civ 5, at [114] *per* Lewison LJ.

reasonable range of conclusions that a properly directed tribunal could have made on the evidence before it."[6] This critical distinction and formulation of the test is of significance, as noted by Lord Justice Mummery in the Court of Appeal:

> "I cannot emphasise too strongly that the issue on an appeal from the tribunal is not whether the appellate body agrees with its conclusions. It is this: as a matter of law, was the tribunal entitled to reach its conclusions? It is a misconception of the very nature of an appeal on a point of law to treat it, as too many appellants tend to do, as just another hearing of the self-same issue that was decided by the tribunal."[7]

Although the Upper Tribunal rules permit it to admit further evidence,[8] it is invariably a high hurdle that needs to be crossed. The Upper Tribunal as an

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[6] *Carter and another v Revenue & Customs Commissioners* [2021] UKUT 300 (TC), at [24]. [Emphasis added].
[7] *Proctor & Gamble UK v HMRC* [2009] EWCA Civ 407.
[8] The Tribunal Procedure (Upper Tribunal) Rules 2008, rule 15(1).

appellate tribunal from the First-tier Tribunal has made clear that:

> "There is no question that this Tribunal has the power to admit evidence that was not available to the FTT: see Rule 15 (2) (a) of the Tribunal Procedure (Upper Tribunal) Rules 2008. We can also do so in the context of agreeing to amend the grounds of appeal."[9]

Yet this approach to the admission of new evidence must only be exercised in limited circumstances. There are several such exceptions in which new evidence may be admitted: first, where they has been a reasonable misunderstanding; secondly, where both parties agree that new evidence ought to be admitted; thirdly, where important and credible evidence has come to light that could not have been obtained with reasonable diligence per *Ladd v Marshall* criteria; fourthly, where a party has deliberately misled the court on a material matter; fifthly, material has come to light on a matter which one party ought to have properly disclosed; and,

[9] *Clear plc v HMRC* [2016] UKUT 347 (TCC), at [44].

finally, the new evidence renders the original decision unfair.

Reasonable misunderstanding

Whether or not a reasonable misunderstanding has arisen is a difficult one to assess, and is to be judged by the circumstances of each case. As noted almost one hundred years ago by The Lord President (Clyde) in the Court of Session:

> "It seems to me that if we were to send this Case back for further inquiry about this, we might be exposed, as far as I see, in almost any case, to an exactly similar application-whenever, in short, the Appellant has not presented his case to the Commissioners in a way which brings out the point he ultimately desires to make before the Court of Appeal. That would never do. No doubt, if there has been a misunderstanding, we would strain a point to put that right; and if the Commissioners had failed to include or to allude sufficiently to some topic that was brought before them by way of evidence we should remit to put that right. But on

> the grounds I have indicated it is impossible to grant the Appellant the indulgence which he asks in this case."[10]

The problem with what the Court of Session indicated, is that it is not entirely clear what might amount to a misunderstanding. In its broadest terms, a party may seek to argue that they had not understood the rules of evidence properly, or that they had not appreciated the burden of proof lay with them to discharge. Such ignorance of the law and its administration is no defence however. Even litigants in person are not afforded this indulgence. As noted in *Hurley v Taylor* where a litigant in person was seeking to admit new evidence at the appellate stage:

> "I have considerable sympathy with any taxpayer who acts in person in a case such as this where there were complicated issues to be considered. However, I do not believe that that is enough to excuse the failure to introduce a piece of evidence like this statement. The taxpayer knew

[10] *R A Bird & Co v The Commissioners of Inland Revenue* (1924) 12 TC 785, at 795. [Emphasis added].

> that the loans from his father were a central issue in the case…"[11]

Whilst each case undoubtedly turns on its own facts, if one bears in mind the cautious approach to the admission of new evidence at the appellate stage, coupled with the fact that there is no clear definition as to what may amount to a misunderstanding (even where a litigant in person is concerned), this exception appears to be almost insurmountable.

Agreement of both parties

Very little needs to be said on this point save for the fact that it does occasionally transpire, that parties agree that the admission of new evidence at the appellate stage is appropriate. It is unlikely that an appellate court will disagree with this, but it is within the gift of the courts/tribunals to do so.

Ladd v Marshall test: important, credible evidence that could not have been obtained with reasonable diligence

The test established in *Ladd v Marshall*[12] came about on account of one of the witnesses having admitted

[11] *Hurley v Taylor* [1999] STC 1, at 8 *per* Aldous LJ.
[12] *Ladd v Marshall* [1954] 1 WLR 1489.

that they had not been entirely truthful at trial. Lord Denning in handing down his judgment in the Court of Appeal stated:

> "It is very rare that application is made to this Court for a new trial on the ground that a witness has told a lie. The principles to be applied are the same as those always applied when fresh evidence is sought to be introduced. In order to justify the reception of fresh evidence or a new trial, three conditions mast be fulfilled: first, it must be shown that the evidence could not have been obtained with reasonable diligence for use at the trial: second, the evidence most be such that, if given, it would probably have an important influence on the result of the case, though it need not be decisive: thirdly, the evidence must be such as is presumably to be believed, or in other words, it must be apparently credible, though it need not be incontrovertible."[13]

[13] *Ladd v Marshall* [1954] 1 WLR 1489

So what is the continued relevance of the *Ladd v Marshall* test and its formulation and application today? As noted in *Terluk v Berezovsky*,[14] the Court of Appeal stated that *Ladd v Marshall* had to be balanced against the overriding objective of doing justice.[15] It made it plain that a balancing act needs to be undertaken:

> "The *Ladd v Marshall* criteria remain important ("powerful persuasive authority") but do not place the court in a straitjacket (*Hamilton v Al-Fayed (No 4)* [2001] EMLR 15 *per* Lord Phillips MR as he then was at para 11). The learning shows, in my judgment, that the *Ladd v Marshall* criteria are no longer primary rules, effectively constitutive of the court's power to admit fresh evidence; the primary rule is given by the discretion expressed in CPR 52.11(2)(b) coupled with the duty to exercise it in accordance with the overriding objective. However the old criteria effectively occupy the whole field of relevant considerations to

[14] *Terluk v Berezovsky* [2011] EWCA Civ 1534.
[15] *Terluk v Berezovsky* [2011] EWCA Civ 1534, at [32].

> which the court must have regard in deciding whether in any given case the discretion should be exercised to admit the proffered evidence."[16]

The Civil Procedure Rules are not binding before the Tax Tribunals, but they carry persuasive authority and the need for justice to be done as part of the overriding objective is echoed in both the First-tier and Upper Tribunal (Tax Chamber) Rules. In the tax arena specifically, the *Ladd v Marshall* test continues to be applied and has *"persuasive authority as to how to give effect to the overriding objective"* particularly where *"fairness between the parties"*[17] is identified as a compelling reason.

The admission of new evidence cannot be taken lightly in circumstances where prejudice is likely to be caused to one party owing to several factors: it was not aware of the evidence and has not had a chance to properly test it; or, it failed to provide the evidence at an earlier stage. In both instances, the Tax Tribunals have set out considered approaches. In *Reed Employment*, the Upper Tribunal accepted

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[16] *Terluk v Berezovsky* [2011] EWCA Civ 1534, at [32].
[17] *Reed Employment Plc v HMRC* [2014] UKUT 160 (TCC), at [97].

HMRC's position that if *"fresh evidence is admitted there will be prejudice to HMRC because it will have to deal with the new evidence several years after the event in circumstances in which all its own witnesses have completed their evidence."*[18] Where the other part was aware of the evidence, the Upper Tribunal have again made clear that a balance needs to be struck between what was available and what the contents of those documents is, versus what is being asked to be admitted as new evidence.[19]

Noting the *Ladd v Marshall* principles, parties should be alive to the fact that the duty of ongoing disclosure remains incumbent until the end of a trial. As noted in *Karoulla*:

> "HMRC cannot hide behind the absence of any tribunal order for disclosure to argue that the evidence "could have been obtained with reasonable due diligence". The many repeated requests by Karoulla for HMRC to return the documents are due diligence enough without the needless expense and use of resource

[18] *Reed Employment Plc v HMRC* [2014] UKUT 160 (TCC), at [100]-[102].
[19] See: *HMRC v Barkas* [2014] UKUT 558 (TCC), at [26].

> generated by requiring an order for disclosure."[20]

Material that ought to have been disclosed

Bearing in mind the duty of ongoing disclosure, the courts and tribunals approach the matter as a balancing exercise taking all factors into account. Such factors include, *inter alia*: where relevant evidence was not made available thus rendering the hearing unfair; and, the manner in which the hearing was conducted such that it amounts to an error of law.

Remedying such an error requires looking at what the material evidence is that was not disclosed and assessing whether it would make any material difference to the outcome. It is not always the case that evidence which ought to have been disclosed will have any impact on the result.[21]

Deliberately misleading the court

It seems axiomatic to state that where a court at first instance was deliberately misled, then evidence that

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[20] *Karoulla v HMRC*[2018] UKUT 255 (TCC), at [31].
[21] See, for example: *HMRC v Household Estate Agents Ltd* [2007] EWHC 1684 (Ch), at [60].

can be subsequently procured to remedy the position should be admitted before an appellate court or tribunal. This is the position adopted not only by the High Court,[22] but also the Tax Tribunals as set out in *Brady*:

> "I strongly suspect that Mr Bushell deceived the Court when he gave evidence to the commissioners. If he did it would be wrong that the decision he obtained from the commissioners should stand. Compared with that, the factor that in the absence of error of law on the part of the commissioners there would be no means of getting in the new evidence short of a separate action alleging fraud is of relatively minor significance. I see no good reason why the Special Commissioners should be required to approach their task in blinkers, denied the benefit of the new evidence which is known to be available."[23]

[22] See, for example: *Meek v Fleming* [1961] 2 QB 366, at 379.
[23] *Brady v Group Lotus* [1987] STC 635, at 641.

Deliberately misleading a court leads to a host of other issues for parties and witnesses, but remedying that imbalance with the admission of new evidence would be appropriate in light of the overriding objective to achieve fairness.

New evidence rendering the original decision unfair

Following on from the above and noting the importance of justice being done in light of the overriding objective, it will come as no surprise that in circumstances where new evidence comes to light that renders the original decision unfair then it will generally be the position that the courts and tribunals will accept this at the appellate level.

However, the admission is not automatic and again comes with considerations to be borne in mind: including the fact that the evidence has not been properly tested at a fact-finding trial; whether or not the evidence was in fact publicly available (for example, HMRC guidance); and, whether the evidence would have had a material bearing on the outcome.[24]

[24] See: *Carter and another v Revenue & Customs Commissioners* [2021] UKUT 300 (TC), at [58]-[64].

Conclusion

It appears that the overall objective of seeking to ensure fairness, all circumstances considered, is the driver behind whether or not new evidence will be admitted at the appellate stage before a court or tribunal. It is a difficult threshold to clear, and a party seeking to admit new evidence at that stage must be clear on why the evidence is being produced at such a late stage, why it was not made available earlier and critically, what exception gateway it falls within the embrace of in order to be permitted.

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Members of chambers have considerable experience in dealing with litigation and evidence at all levels of court and tribunal, and chambers' lunchtime discussions concerning the admission of evidence at the appellate stage are what prompted this article to be written – which it is hoped will be of assistance to those reading it.

ESG-LINKED STRUCTURED PRODUCTS: ECONOMIC PROPERTIES, ACCOUNTING AND TAX TREATMENT

Oktavia Weidmann

Oktavia Weidmann[1]

Ultimately, incentive structures and systems drive ESG investing, which can be disingenuous. Structurally, public market investors continue to focus on the incentives which maximize their financial returns, even while taking certain ESG inputs into account in their portfolio allocations. Only by regulating and incentivizing the actual outcomes might investors alter their investment strategies towards new rewards based on ESG outputs.

— Roger Spitz, The Definitive Guide to Thriving on Disruption: Volume IV - Disruption as a Springboard to Value Creation

[1] Oktavia is a barrister and university lecturer in banking and finance law and international tax law.

The author introduced the learned readers to ESG derivatives in the 15th FCTC Digest.[2] In this follow-up article, the author goes one step beyond and discusses ESG-linked structured products and investigates related regulatory, accounting and taxation questions. The author admits that the following article is not entirely comprehensive – topics like ESG and transfer pricing have not been discussed as this would require a deeper investigation into the matter, which goes beyond the space of the Digest. The article should instead serve as an overview and inspiration for the readers of this Digest to think a little bit more about the topic of ESG and related investment products as in the times of climate change and significant geopolitical shifts, the subject of ESG becomes of more relevance not only for investors and our clients in their business decisions but also in the context of regulating, accounting and taxing those instruments.

Beyond greenwashing considerations and the regulatory attempts which seek to standardise what

[2] Oktavia Weidmann, ESG derivatives, the legal and economic design of ESG derivatives and their regulatory, accounting and tax treatment part 1, 15th FCTC Digest, 160-186.

ESG-compliant investments are, the author considers the following questions in this article:

(1) What is ESG?

(2) What are ESG investments?

(3) What are ESG-linked structured products?

(4) How will ESG-linked structured products be accounted for?

(5) How should they be taxed?

(1) What is ESG?

ESG stands for environmental, social and governance. Beyond this literal meaning of the three words, ESG is, first and foremost, a concept.

But what is this concept good for?

ESG is a framework that is 'used to assess an organization's business practices and performance on various sustainability and ethical issues'.[3]

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3 Sandra Mathis and Craig Stedman, What is environmental, social and governance (ESG)?, TechTarget, March 2023,

The factor *environmental* describes a company's 'overall impact on the environment and the potential risks and opportunities it faces because of environmental issues,' whereas the factor *social* evaluates how 'a company treats different groups of people: employees, suppliers, customers, community members and more'.[4] The factor *governance* focusses on 'internal controls and practices to maintain compliance with regulations, industry best practices and corporate policies'.[5]

In terms of investments, the fulfilment or non-fulfilment of ESG criteria are a way to measure business opportunities or risks in the ESG realm. Thus, some investors use ESG criteria to evaluate a company's 'ethical' performance and make investment decisions accordingly.

It should be noted that tax itself has become an ESG factor. The 2020 World Economic forum 'has outlined "total tax paid" as a reportable metric to

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https://www.techtarget.com/whatis/definition/environmental-social-and-governance-ESG, accessed 1 September 2023.

[4] Sandra Mathis and Craig Stedman, What is environmental, social and governance (ESG)?

[5] Sandra Mathis and Craig Stedman, What is environmental, social and governance (ESG)?

reflect a corporation's contribution to public finances through direct and indirect tax, [and] 'to disclose their progress in the ESG areas of people, planet, prosperity and governance.[6]

Consequently, some investors factor in the 'total tax paid' in deciding whether to (or continue to0 invest in company or not.[7] KPMG highlights that

> Institutional investors are starting to use this information to make informed investment decisions. [...] A group of Danish pension funds have developed and signed a Tax Code of Conduct to help support goals of responsible tax behaviour in their investments and through their investment partners. Actions like these underscore the public approach investors are taking in

[6] KPMG, ESG and Tax: Increasing Importance to Institutional Investors, 2021, https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2021/09/esg-and-tax.pdf, accessed 2 September 2023.
[7] KPMG, ESG and Tax: Increasing Importance to Institutional Investors, 2021.

> supporting tax as a critical component of ESG.[8]

The author believes that particularly those multinationals which pay little or no tax and have been targeted by recent anti-base erosion and profit shifting (BEPS) initiatives, such as the OECD's Pillar One and Two, will come under more scrutiny from ESG-inspired investors.

Basically, investors may start distinguishing between ESG-compliant companies as those that are transparent in their tax dealings, pay their fair share of tax) and *non-ESG compliant companies* as those which employ aggressive tax optimisation strategies as described in the OECD's/G20 BEPS project.

Thus, the author predicts that the ESG factor of 'governance' will gain increased importance within the ESG-triad in the future.

(2) What are ESG investments?

ESG investments have been defined as strategies where people put their money to work in companies that have a positive net impact on the environment

[8] KPMG, ESG and Tax: Increasing Importance to Institutional Investors, 2021.

and society, led by a management team that achieves these goals via better corporate governance.[9]

Because banks want to meet the increasing demand for ESG products also new ESG-linked structured products are invented that target private investors through ETFs and structured notes but also institutional investors in form of ESG derivatives. Many companies want to appear ESG-friendly, although there are in fact not because investors increasingly seek to invest into ESG products.

Thus, investors have to be careful to not fall prey to 'greenwashing' which is a practice of making a product, policy or activity appear to be more environmentally friendly, socially responsible, or in line with positive governance policies than it is in reality. ESG investments fall in three main categories being ESG derivatives, ESG investment funds and ESG-linked structured products which are discussed below.

(3) ESG-linked structured products

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[9] Barbara Friedberg, The Best ESG Funds in 2023, Forbes Advisors, 1 September 2023, https://www.forbes.com/advisor/investing/best-esg-funds/, accessed 5 September 2023.

In terms of types of ESG-linked structured products, the author discusses more traditional ESG factors, like climate and sustainability-related factors as those are structured products which are currently marketed to investors.

To define and categorise ESG-linked structured products, it is beneficial to consider what structured products are.

(a) Structured products in general

Morningstar describes structures products as follows:

> One other key characteristic of structured products is that the return an investor receives from a structured product is linked to the performance of a financial asset, like a stock, commodity, or index. But the link to the underlying investment is not straightforward. Instead, like Frankenstein's monster, the component parts of structured products are sewn up into a note and reanimated—often with flashy payoff profiles borrowed from

exotic exchange-traded option strategies.[10]

In the book *Taxation of Derivatives*, the author provides a definition of structured products for tax purposes as structured products being legally inseparable linear combinations of at least two non-structured products, which consists of

(1) at least one non-derivative, traditional financial instrument; and

(2) one or more derivatives.[11]

Both definitions (the economic and the tax definition) will serve as a basis for the following discussion.

(b) ESG-linked structured products

ESG-linked structured products are a relatively new phenomenon. The first US ESG-linked structured product was issued in 2018 by the Bank of America Merryll Lynch which was the arranging bank for the

[10] Morningstar, Understanding structured products in 4 charts (8 May 2023) https://www.morningstar.com/alternative-investments/understanding-structured-products-4-charts, accessed 27 August 2023.
[11] Oktavia Weidmann, Taxation of Derivatives (2015), Chapter 8, §8.02 [A], 137, 2nd edition forthcoming November 2023.

so-called *Providus Collateralised Debt Obligation I*, managed by Permira Debt Managers.[12] The first European Residential Mortgage Back Security was issued in 2016 under the name *Green Storm 2016*.[13] Bloomberg confirms that ESG-linked structured products issuance has surged in recent years going from zero to around $10-15 billion, partly driven by investors looking to customize their exposure to ESG factors. This sharp increase reflects a wider trend: there were over $35 trillion ESG assets under administration in 2020, a number estimated by Bloomberg Intelligence to exceed $50 trillion by 2025.[14]

ESG-linked structured products have seen an exceptional growth in recent years.

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[12] PRI – Principles for Responsible Investments, ESG incorporation in securitised products: challenges ahead (May 2021) https://www.unpri.org/download?ac=13412, accessed 25 May 2023, 10.

[13] PRI – Principles for Responsible Investments, ESG incorporation in securitised products: challenges ahead, 11.

14 Nitin Ananda, Bloomberg Professional Services, 'How to analyze, create, and risk-manage ESG-linked structured products' (29 May 2022), https://www.bloomberg.com/professional/blog/how-to-analyze-create-and-risk-manage-esg-linked-structured-products/, accessed 2 September 2023.

While the European Union's pledge to issue 225 billion euros in green bonds and the ECB's asset-buying program should sustain the ESG debt market, the global race to net-zero emissions may accelerate the market share of the debt as an asset class. Sellers include not only companies, but also countries such as the U.K. and Canada as well as potential issuance by emerging economies such as Ghana. BlackRock was the top holder of green bonds with $12.5 billion in assets as of June (doubling its position within the past six months), increasing its market share by 2.5% to 7.3%, followed by Vanguard (4.65%), Allianz (4.47%), Credit Agricole and Japan Pension Fund (both at 2.6%).[15]

The incorporation of ESG elements in structured products is, however, still in its infancy due to their complex nature,[16] although 'the market is showing

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[15] Bloomberg Intelligence, Game on! ESG debt issuance passes $ 3 trillion with record speed, 21 June 2021, https://www.bloomberg.com/professional/blog/game-on-esg-debt-issuance-passes-3-trillion-with-record-speed/, accessed 26 May 2023.

[16] PRI – Principles for Responsible Investments, ESG incorporation in securitised products: challenges ahead (May 2021) https://www.unpri.org/fixed-income/esg-incorporation-in-securitised-products-the-challenges-ahead/7462.article, accessed 25 August 2023.

demand for structured products that allow buyers to build specific exposure to ESG sectors while maintaining bespoke risk characteristics.'[17] European *ESG Collateralised Loan Obligations* have proliferated, while the green, social and sustainability-labelled issuance of other products is also developing. Investors are looking at how to build frameworks to assess ESG factors across all securitised products and to determine whether ESG-labelled securitised products are genuine.[18]

There can be various assets underlying those ESG securitised products such as residential and commercial mortgages or pools of corporate loans.

Underlying assets of those *ESG-linked asset-back securities* can also be consumer products, such as car loans or credit card receivables.[19] 'Among popular ESG investments are notes that offer high coupons

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[17] Luca Wappenschmidt, Bloomberg Professional Services, ESG structured products rise to meet investor demands, (29 May 2022), https://www.bloomberg.com/professional/blog/esg-structured-products-rise-to-meet-investor-demand/?bbgsum-page=DG-WS-PROF-BLOG-POST-137418&tactic-page=630365, accessed 2 September 2023.

[18] PRI – Principles for Responsible Investments, ESG incorporation in securitised products: challenges ahead.

[19] PRI – Principles for Responsible Investments, ESG incorporation in securitised products: challenges ahead.

on condition that an underlying equity index breaks a certain level.'[20] Those products seem however more a traditional barrier structured product, an example which can be seen below.

Example (based on Bloomberg)[21]

A *standard autocallable note* is *linked to the MSCI World ESG Leaders Index*. It pays a coupon if the underlying index passes an upside barrier, at which point it automatically matures and the investor's principal is returned.

If the ESG index goes up by 10% in its first year, the note is redeemed early and the investor can accrue a coupon of around 21%, while the investor is protected against any decline in the ESG index of less than 20% on a structured note priced at 100.

There are, however, certain challenges.

Bloomberg states that ESG investments are only as sound as the data that feeds them. Without reliable and comparable data sets, investors are sailing blind,

[20] Luca Wappenschmidt, Bloomberg Professional Services, ESG structured products rise to meet investor demands.
[21] Luca Wappenschmidt, Bloomberg Professional Services, ESG structured products rise to meet investor demands.

vulnerable to greenwashing and dependent on divergent standards and anecdotal evidence to orientate their investments.[22]

On the other hand, fund managers may have difficulty to explain why they have taken some investment decisions in light of an increasing ESG awareness which can easily lead to investor scrutiny.[23]

There is progress, however. 'More ESG-linked investment products are being released as the European Union supports sustainable investment activities, including a taxonomy of activities regulators will promote or punish.'[24]

The EU has issued various regulations and a Directive in the ESG space, namely the Sustainable Finance Disclosures Regulation (SFDR),[25] the

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[22] Nitin Ananda, Bloomberg Professional Services, "How to analyse, create, and risk-manage ESG-linked structured products."

[23] Nitin Ananda, Bloomberg Professional Services, "How to analyze, create, and risk-manage ESG-linked structured products."

[24] Luca Wappenschmidt, Bloomberg Professional Services, "ESG structured products rise to meet investor demands."

[25] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.

Corporate Sustainability Reporting Directive (CSRD)[26] and the Taxonomy Regulation.[27]

Those regulations and the CSRD 'tighten disclosure requirements and help standardize definitions of what constitutes green. Also, other areas of the globe, like for example the Asia Pacific are working on their own taxonomies. Until there is more clarity on what constitutes green finance, ESG-focused investors will still have to deal with greenwashing issues, however.

The EU proposed the *Green Bond Standard*. That standard lays 'the foundation for a common framework of rules for issuers to use the designated *European Green Bond* for bonds where the use of proceeds is aligned with the EU Taxonomy Regulation.'[28] The Green Bond Standard was expected to reach political agreement during the first half of 2023.[29] So far, the EU co-legislators have only

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[26] Directive 2022/2464/EU on corporate sustainability reporting; compare also: Nitin Ananda, Bloomberg Professional Services, "How to analyze, create, and risk-manage ESG-linked structured products."

[27] Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment and amending Regulation (EU) 2019/2088.

[28] Linklaters, ESG Legal Outlook 2023, 8.

[29] Linklaters, ESG Legal Outlook 2023, 8.

reached a provisional agreement on the standard.[30] In the UK, the Financial Conduct Authority ("FCA") confirmed in 2022 that it is not currently proposing to develop a UK version of a green bond standard and expressed support for existing industry standards.[31]

(c) Subcategories of ESG-linked structured products, ISDA definitions and regulation

There is a kaleidoscope of ESG-linked structured products such as green ASB (asset backed securities) bonds, sustainability-linked bonds, green bonds, social bonds, sustainability-linked loans, green loans and sustainability bonds.[32]

In the realm of ESG-linked structured products, there are ESG Collateralised Loan Obligations, ESG-linked securitised products, such as residential or commercial mortgage back securities, other ESG-linked asset backed securities, bonds with some ESG

[30] Paul Tang, An establishment of an EU Green Bond Standard, 20 August 2023, https://www.europarl.europa.eu/legislative-train/theme-an-economy-that-works-for-people/file-eu-green-bond-standard, accessed 2 September 2023.
[31] Linklaters, ESG Legal Outlook 2023, 7.
[32] Bloomberg Intelligence, Game on! ESG debt issuance passes $ 3 trillion with record speed.

factor, and structured products that package carbon credits.

One can put those instruments broadly in three buckets: (i) those products which are securities to pass on some ESG and other risks, (ii) dedicated structured products which include among other components, some ESG element, and (iii) regard carbon-credit structured products. Within the third subcategory, one can expect increasing investor demand due to the introduction of the 2022 ISDA Verified Carbon Credit Transaction Definitions (the ISDA VCC Definitions).[33]

The 2022 ISDA Verified Carbon Credit Transaction Definitions 'are in the form of a standard definitional booklet for physically settled secondary market Verified Carbon Credit (VCC) transactions and are accompanied by template confirmations for VCC spot, forward and option transactions.[34]

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[33] ISDA, 2022 ISDA Verified Carbon Credit Transaction Definitions, https://www.isda.org/book/2022-isda-verified-carbon-credit-transaction-definitions/, accessed 28 May 2023.
[34] Leane Bannfield, Linklaters, Derivatives and Structured Products Legal Outlook 2023, https://www.linklaters.com/en/insights/publications/legal-outlook/2023/derivatives-and-structured-products, accessed 28 May 2023.

The world of carbon credits, carbon allowances and carbon offsets has fast become a world of its own. Whereas a carbon allowance is the amount of greenhouse gas emissions 'a company has the legal right to emit, a carbon credit is 'a unit of measurement for those emissions.'[35] Carbon credits are in this respect a financial market-based instrument which is used to put a price tag on a specific amount of carbon emissions (usually one metric ton of carbon dioxide emissions or its equivalent (tCO2e)) and trade it at a secondary market.[36]

Carbon credits could be somehow viewed as some form of commodity and investors and manufactures may not only use ESG derivatives but also specifically tailored carbon credit-linked structured products to hedge their exposure a rising costs of their carbon allowances, mirrored by an increase in the price of carbon credits. For accounting purposes, carbon credits are likely seen as intangible assets.

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[35] EcoCart, What are Carbon Credits? Carbon Credits v Carbon Offsets, 29 December 2022, https://ecocart.io/what-are-carbon-credits-carbon-credits-vs-carbon-offsets/, accessed 5 September 2023.
[36] EcoCart, What are Carbon Credits? Carbon Credits v Carbon Offsets.

In the context of other ESG-linked structured products, [s]ustainable notes and repackagings remain a key mechanism for providing investors with sustainable investments in a familiar format. As well as green or blue bonds being repackaged and sustainable payouts being included, sustainable commodities can be used to create a "green" product.[37]

Bannfield predicts that also in 2023, 'green regulatory capital transactions/ synthetic securitisations' and ESG CLOs will enjoy popularity, with the market focusing on how ESG can be integrated into these products ahead of the development of a specific sustainable securitisation framework, and investors in them seeking assistance from arrangers in meeting their regulatory disclosure obligations.[38]

Further, *Bannfield* sees green structured products firmly established in the market with increased focus on the social factor, for example 'significant interest in social financing structures designed to facilitate

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[37] Leane Bannfield, Linklaters, Derivatives and Structured Products Legal Outlook 2023.
[38] Leane Bannfield, Linklaters, Derivatives and Structured Products Legal Outlook 2023.

financing into a developing country' which can be in note or loan form, 'often backed by insurance or a guarantee given by a World Bank entity'[39]

The ESG market keeps growing although there has been some slowing during the global pandemic, Linklaters observes a trend to more sophistication and diversity in the product categories, stating that overall issuance levels of green, social and sustainable bonds and other labelled bonds such as blue bonds, transition bonds and sustainability-linked bonds were more muted in 2022 as compared to previous years, those that did proceed demonstrated an increasingly sophisticated and nuanced product.[40]

For example, in 2022, the World bank issued the first of its kind 'conservation bond', called the 'Rhino Bond'.[41]

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[39] Leane Bannfield, Linklaters, Derivatives and Structured Products Legal Outlook 2023

[40] Linklaters, ESG Legal Outlook 2023, 7, https://lpscdn.linklaters.com/-/media/digital-marketing-image-library/files/01_insights/publications/legal-outlook/2023/linklaters_esg-legal-outlook-2023.ashx?rev=bbb9e054-d57b-4cc7-aaf1-565cf9a2b9cc&extension=pdf&hash=B0956C799EF9661F42F6463E880EA5F9, accessed 28 May 2023.

[41] Linklaters, ESG Legal Outlook 2023, 8.

(4) Accounting of ESG-linked structured products

The author proposes that the accounting treatment of those ESG-linked structured products will follow the accounting treatment of the main instrument. For example, if there is an ESG-linked CLO, those CLOs will be accounted for as normal CLOs. The same applies to ESG-linked ABS or similar products.

Deloitte states in relation to sustainability-linked debt instruments with cash flows linked to environmental factors that the main question is if the arrangement contains an embedded derivative that must be accounted for separately on the basis of the applicable accounting guidance. In many instances, this assessment depends on whether the variability linked to the environmental factors includes economic risks that are not clearly and closely related to the debt instrument itself.

If a company determines that a sustainability-linked debt instrument includes an embedded derivative, such a derivative must be accounted for separately at fair value both at the inception of the arrangement and for the life of the arrangement. The determination of the fair value of environmental-

factor-related embedded derivatives involves complexity and often requires the involvement of valuation specialists.[42]

That means that the ESG-linked structured products follow mainly the accounting treatment of other, more common structured products although the fair value determination of the ESG element bears some difficulties.

Problems are however likely to arise in the context of IFRS and other accounting standards if carbon credits are seen as intangible assets with no depreciation. The game of writing them down in value if the prices drop while maintaining the intangible assets at the lower historical cost value when carbon credit prices rise, may be played again as it is already the case for cryptoassets.

What the new IFRS Sustainability standards issued by the International Sustainability Standards Board (ISSB) in June 2023, named IFRS S1 and S2, will bring for the future, remains to be seen.

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[42] Deloitte, Accounting and financial implications of ESG initiatives, https://www2.deloitte.com/us/en/pages/audit/articles/hu-accounting-reporting-esg.html, accessed 27 May 2023.

In 2021, the ' IFRS Foundation formally announced the creation of the International Sustainability Standards Board' which acts in parallel to the IASB under the IFRS Foundation.[43] IFRS S 1 concerns *General Requirements for Disclosure of Sustainability-related Financial Information*, and IFRS S2 deals with *Climate-related Disclosures*.

Although the ISSB tentatively decided to the effective date for IFRS S 1 and S2 to be 1st January 2024,[44] the individual jurisdictions will decide if they want to apply them.[45] Earlier application is allowed but only if both standards are applied.[46]

Some companies may choose to adopt those standards voluntarily, thereby responding to

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[43] KPMG, IFRS announce new ESG reporting standard, 2021 https://kpmg.com/dp/en/home/insights/2021/10/ifrs-announce-new-esg-reporting-standard.html, accessed 27 May 2023. Compare also: Robert G. Eccles and Bhakti Mirchandani, We Need Universal ESG Accounting Standards, Harvard Business Review, 15 Feb. 2022, https://hbr.org/2022/02/we-need-universal-esg-accounting-standards, accessed 27 May 2023.

[44] PWC, Latest News from the Standardsetters and Regulators (23 May 2023).

[45] KPMG, Get ready for global sustainability standards (18 May 2023).

[46] PWC, Latest News from the Standardsetters and Regulators (23 May 2023).

investor and/or societal pressure.[47] The introduction will not come in full force from the beginning as the ISSB will 'provide various reliefs in the first year of adopting IFRS Sustainability Disclosure Standards – for example [...] allowing entities to not disclose Scope 3 GHG[48] emissions.[49]

Eccles and Mirchandani outline in their article that the ISSB will provide a "global baseline" for high-quality sustainability reporting that will support the work being done in the U.S. by the Securities and Exchange Commission (SEC) and the European Union (EU)'s "Corporate Sustainability Reporting Directive (CSRD)." The ISSB is focused on "single materiality" or the ESG information that drives

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[47] KPMG, Get ready for global sustainability standards (18 May 2023).

[48] 'The Corporate Value Chain (Scope 3) Accounting and Reporting Standard allows companies to assess their entire value chain emissions impact and identify where to focus reduction activities.' See: Greenhouse Gas Protocol, Corporate Value Chain (Scope 3) https://ghgprotocol.org/corporate-value-chain-scope-3-standard, accessed 27 May 2023. The Corporate Value Chain Accounting and Reporting Standard can be found at: Greenhouse Gas Protocol, Corporate Value Chain (Scope 3) Accounting and Reporting Standard, https://ghgprotocol.org/sites/default/files/standards/Corporate-Value-Chain-Accounting-Reporing-Standard_041613_2.pdf, accessed 27 May 2023.

[49] PWC, Latest News from the Standard setters and Regulators (23 May 2023).

valuation and matters to investors. This is also the focus of the SEC and so the mandates are consistent. In contrast, the CSRD has a broader "double materiality" mandate which means it will cover information of interest to stakeholders even if it is not of interest to investors. Linking the two is the concept of "dynamic materiality" — ESG issues that investors don't care about today can become ones they care about in the future. The most striking current example is climate change.[50]

The authors state that the ideal outcome of that standard setter would be standards that are focussed on investor needs.[51]

KPMG suggests that IFRS S 1 and S2 'aim to create a global baseline for investor-focused sustainability reporting that local jurisdictions can adopt or build into its own local requirements'.[52]

Some accounting standard setters are already at the forefront of creating sustainability reporting

[50] Robert G. Eccles and Bhakti Mirchandani, We Need Universal ESG Accounting Standards, Harvard Business Review.
[51] Robert G. Eccles and Bhakti Mirchandani, We Need Universal ESG Accounting Standards, Harvard Business Review.
[52] KPMG, Get ready for global sustainability standards (18 May 2023).

standards that are adapted to their jurisdictions. For example, the Australian Accounting Standards Board released a consultation paper in December 2022 'that seeks initial views on proposals to introduce standardised, internationally aligned legislative requirements for disclosure of climate-related financial risks and opportunities from financial years 2024-25 in Australia.'[53]

The author believes that the accounting of ESG structured products will be rapidly developed and defined within the next few years due to the need of investors to better disclose, classify and measure ESG risks entailed in ESG structured products as well as ESG derivatives. This will come with its challenges, too, in particular if the accounting treatment of carbon credits is again utilised to create some favourable tax outcome for investors who keep those credits in their books not only for speculation or hedging purposes but also to improve their post-tax outcome.

(5) Taxation of ESG-linked structured products

[53] KPMG, Get ready for global sustainability standards (18 May 2023).

In relation to ESG-linked structured products, one needs to ask how they are taxed. The author believes that the existing rules of bifurcation or integration for tax purposes are sufficient to tax also ESG-linked structured product.

The main reason is that ESG is not some new asset class like cryptoasset but it is just a factor in the pricing formula or marketing in a structured product. That means the underlying products are traditional products and should be taxed accordingly. The ESG factor may have been separately valued and measured, and then taxed.

The author proposes that the approach should be as follows:

1. Determine the economic properties of the ESG-structured product. Is it an asset back security (ABS), a CLO, a structured certificate or something else?

2. Determine what accounting standard the company holding or issuing the structured products uses (FRS 102, section 11 or section 12, IFRS 9 or IAS 39).

3. According to the used accounting standard, determine if the structured product is bifurcated or integrated for accounting purposes according to the applicable traditional rules. In particular, determine if the ESG element constitutes some embedded derivative.

4. The taxation rules of CTA 2009, sections 585 or 586 are applied depending on whether the host contract is an underlying loan relationship or another contract – neither being loan relationships nor hybrid derivatives with an embedded derivative according to CTA 2009, section 586.

In relation to carbon credits – which can serve as an underlying for ESG derivatives or ESG-linked derivatives – one needs to investigate in more details how they are treated for accounting purposes and what that could mean not only for their accounting treatment including impairment losses but also in the context of taxing them. An article in the next FCTC Digest will try to analyse this very new phenomenon.

(6) Conclusion

Unlike cryptoassets, one may not yet regard 'ESG' as a new asset class but rather a new trend to categorise traditional instruments as '*environmental, social or governance'*-friendly. That may, however, not be the full picture.

Particularly carbon credits have the potential to be seen as a new asset class altogether – again something intangible, yet valuable emerging which we have seen before with the rise of cryptoassets. Further, with the introduction of the IFRS® Sustainability Disclosure Standards IFRS S 1 and S2 and beyond, there is the clear trend by the IASB to give the accounting of the ESG element in derivatives or structured products or other financial instruments a complete framework to properly disclose them in the financial accounts. IFRS S 1 and S2 are intended only as the beginning.

As a rule of thumb, the author proposes that it is decisive for the taxation of ESG-linked structured products to determine what the actual structured product is in its substance, and the tax the ESG-linked structured products according to the rules of this instrument category.

However, one may want to watch and see how the taxation of new ESG-linked structured products and derivatives and in particular those relating to carbon credits will develop. An investigation of the nature of carbon credits and some thoughts on their taxation and that of related derivatives and structured products will merit a separate article in the next Digest.

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CRYPTO STRUCTURED PRODUCTS – ECONOMIC PROPERTIES, ACCOUNTING AND TAXATION

Oktavia Weidmann

The crypto currency community hasn't decided whether they want to be anarchist rebels or to replace the establishment.

—Adi Shamir (cryptographer)

The following article provides as an overview of crypto structured products as a new subcategory of structured products. Structured products have been used for many years in traditional finance to sell investors complex pay-off profiles, where they usually give up some of the upside of an underlying asset against partial or full downside protection of the price movements of an asset or index. Crypto structured products are no exception to it. They have developed on the back of the introduction of exchange traded crypto derivatives only recently,

with the first crypto structured product being launched in 2021.[1]

1. The economic properties of crypto structured products

Bybit defines crypto structured products as 'packaged investments linked to digital assets to enhance risk-return metrics for investors.'[2] Yield App outlines that Crypto structured products work in much the same way as structured products based on traditional financial market instruments, utilizing derivatives to achieve specific financial outcomes. While derivative products in traditional financial markets are a mature asset class in their own right, they have only relatively recently become available for crypto markets.[3]

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[1] Yield App, An introduction to crypto structured products: Variable risk return profiles, Blog, https://yield.app/blog/intro-crypto-structured-products#:~:text=Structured%20products%20are%20investment%20products,the%20return%20profile%20in%20the, accessed 30 May 2023.

[2] Bybit, Crypto Structured Products: Maximising Yields During Choppy Markets (27 July 2022) https://learn.bybit.com/bybit-shark-fin/crypto-structured-products/ accessed 29 May 2023.

[3] Yield App, An introduction to crypto structured products: Variable risk return profiles.

Trofi Group defines crypto structured products as packaged financial instruments that use a combination of fixed-income asset and derivatives for achieving a risk-return objective, such as principal protection, enhancing yields, or betting on volatility. The performance or value of these financial instruments, or structured products, is linked to that of an underlying asset, product, or index. These could be cryptocurrencies, crypto indices, or a combination of these.[4]

The author believes that this definition comes closest to traditional definitions of structured products as containing a host – usually debt – instrument and one or more embedded derivatives.

Trofi Group observes that most crypto structured products incorporate options.[5]

Yield App explains that Crypto structured products can take many forms depending on the payoff objectives. With over seven times the volatility of equity markets crypto options typically offer larger

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[4] Trofi Group, What are crypto structured products, (4 May 2022), https://blog.trofi.group/what-are-crypto-structured-products-1c3f648f163f, accessed 29 May 2023.
[5] Trofi Group, What are crypto structured products, (4 May 2022).

premiums and therefore more customization options. For example, crypto structured products allow an investor to express a view on the future performance of an underlying digital asset, such as Bitcoin. They can be used to earn yield from the extreme price movements of cryptocurrencies – Bitcoin has moved between roughly $51,000 and $16,000 during 2022 – powering volatility-driven yields as a result.[6]

This all sounds very much like traditional structured products, where some of the products give investors returns in falling equity markets, whereas others provide returns on rising markets, and again others profiting from equity volatility via volatility swaps incorporated in the structured product.

There are a couple of other players around in the market of crypto structured products with the first products launched in 2021.

For example *Trofi Group* offer 'Buffered Return Enhanced Note linked to the performance of

[6] Yield App, An introduction to crypto structured products: Variable risk return profiles.

Ethereum'.[7] *Trofi Group* states that the strategy of this note 'provides leveraged returns along with partial protection on the downside risk. This Note is suitable for stablecoin holders who look to participate in market rallies but are also concerned about downside risk. It is constructed through a combination of fixed-income products, selling put options, and buying call spread options.'[8] Trofi Group provided example terms and a payout profile which are shown below:

Example Terms (taken from Trofi Group *Buffered Return Enhanced Note*)

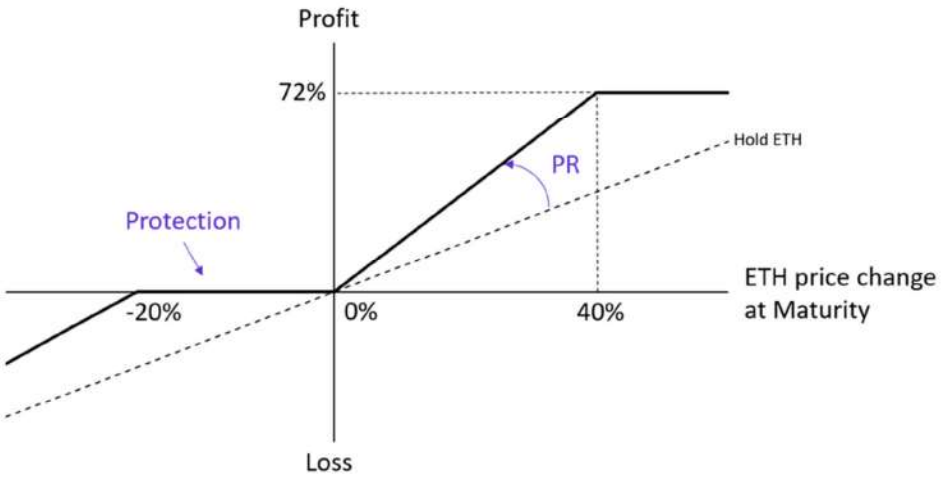
Investment Asset: USDT
Tenor: 6 months
Initial ETH price: $3,000
Put Strike: 80% of initial ETH price (i.e. $2400)
Participation Rate (PR): 180%
Cap: 40%

The put option sold has an out-of-the-money strike, which provides a 20% buffer to the downside price

[7] Trofi Group, What are crypto structured products, (4 May 2022).
[8] Trofi Group, What are crypto structured products, (4 May 2022).

movement of ETH in this example. Note holders may only be exposed to any ETH downside below the Put Strike. The call spread options allow Note holders to participate on the upside performance, capped at 40%, which is magnified by the Participation Rate of 180%.

Buffered Return Enhanced Note — Profit and Loss diagram at Maturity



Source: picture: Trofi Group

At Maturity of the Note:

Scenario 1:

If ETH price is below $2400, let's say $1800, the Note holders receive back 75% of notional in USDT (i.e.

100% principal — the 25% downside performance of ETH from the Put Strike)

Scenario 2:

If ETH price is above $2400 but below $3000, Note holders receive back 100% of notional in USDT.

Scenario 3:

If ETH price is equal to or above $3000, let's say $3900, Note holders receive back 154% of notional in USDT (i.e. 100% principal + the 30% upside performance of ETH, multiplied by the Participation Rate of 1.8x)

Scenario 4:

If the ETH price is above $4200, the maximum redemption is capped at 172% of notional (i.e. 40% Cap x PR 1.8x)

InvestDEFI not only offers various cryptocurrency option strategies but also structured products that track the *investDEFI* volatility index, or the *DEFI*

Blockchain Project Index tracker.[9] The demand for structured products is there because many institutional investors cannot or do not want to invest in cryptoassets directly.[10] Those products do not only include tailor made structured products for large institutional clients but some of them are even exchange traded, such as Exchange-Traded Notes (ETNs).[11]

Another structured product is called 'Sharkfin' which is named after the graph of the payoff profile of the product, and provides investors returns if the market goes moderately up in Bitcoin.[12]

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[9] 'vestDEFY Equal Weight DeFi Index seeks to replicate the top 10 smart contract enabled proof-of-stake (PoS) blockchains which power DeFi and the top 10 DeFi Projects built with blockchain technology. The index constituents are equal weighted, determined through a scoring methodology that factors in market cap and liquidity to arrive at 50% DEFI blockchains and 50% DeFi projects. The index will be rebalanced monthly,' see: investDEFI, Driving the Evolution of Crypto investing, https://www.investdefy.com, accessed 29 May 2023.

[10] Cryptoresearch, Structured Products for Digital Assets, (3 March 2021) https://cryptoresearch.report/crypto-research/structured-products-for-digital-assets/, accessed 29 May 2029.

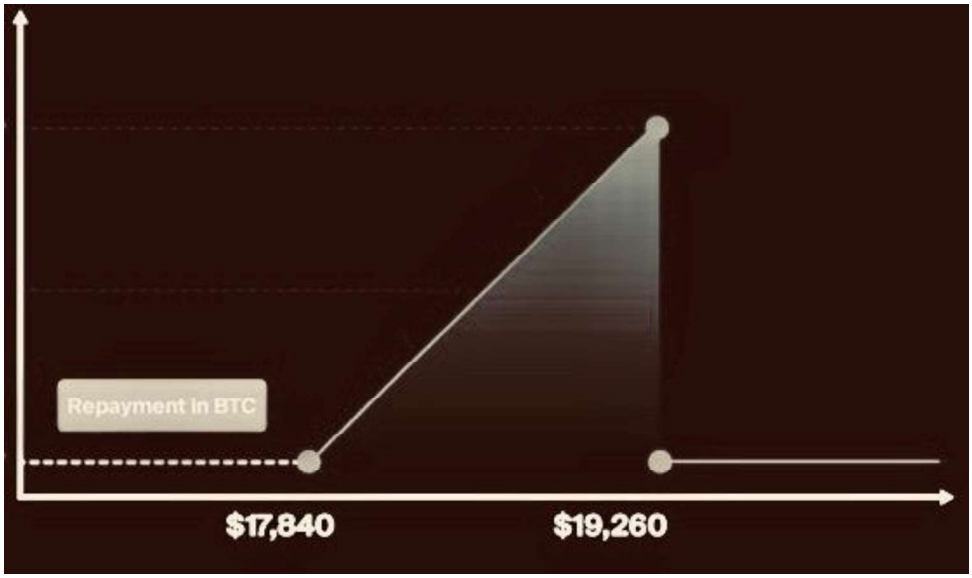
[11] Cryptoresearch, Structured Products for Digital Assets, (3 March 2021).

[12] Yield App, An introduction to crypto structured products: Variable risk return profiles.

Example (taken from Yield App)

The 'Sharkfin' structured product achieves highest returns 'when the price of the underlying asset appreciates but does not exceed a predetermined upper level. [...] if the price falls below the current level or rises above the predetermined upper level, the product still pays a guaranteed minimum coupon (i.e., annual interest). If the price rises above the predetermined level, the investor receives the principal investment back in USDC, plus the minimum coupon (e.g. 15% as in the graph above). If the price falls below the buy level, the investment and the guaranteed coupon gets converted to the underlying asset (e.g. Bitcoin) at the buy level. As such, the downside of this product is that if prices fall, the investor is obliged to buy the underlying asset at a higher-than-market price.'[13]

[13] Yield App, An introduction to crypto structured products: Variable risk return profiles.



Source: Picture: Yield App

The market of exchange-traded crypto structured products is in particular flourishing in Germany. For example, *Boerse Stuttgart* offers those ETNs which mirror the price movements of Bitcoin and Ethereum.[14]

[14] Boerse Stuttgart, Using ETNs to invest in Bitcoin, dollars, etc. https://www.boerse-stuttgart.de/en/products/etps/etns/, accessed 29 May 2023; Boerse Stuttgart, BTCetc Bitcoin Exchange Traded Crypto (BTCE), https://www.boerse-stuttgart.de/de-de/produkte/etps/etns/stuttgart/a27z30-btcetc-bitcoin-exchange-traded-crypto-btce, accessed 29 May 2023.

Eurex has even issued futures on ETNs backed by Bitcoins.[15] *Boerse Frankfurt* has listed an ETC Group Physical Bitcoin, which is an exchange traded fund (ETF) with more than 500 million Euro assets under management.[16]

Although no structured product but an exchange traded fund, it proves that the demand for structured cryptoasset investment products is there.

Risk explains that

> The original crypto structured products were housed in so-called DeFi options vaults (DOVs). Users deposit crypto anonymously into the DOVs – whether that be stablecoins like tether or USDC, or assets such as ethereum (ETH) or bitcoin – and the DOVs go out and run an investment strategy on behalf of the

[15] Deutsche Boerse Group, Eurex announces launch of Bitcoin ETN futures (20 Aug. 2021) https://deutsche-boerse.com/dbg-en/media/press-releases/Eurex-announces-launch-of-Bitcoin-ETN-futures-2713576, accessed 30 May 2023.
[16] Boerse Frankfurt, ETC Group Physical Bitcoin, https://www.boerse-frankfurt.de/en/etf/de000a27z304-etc-issuance-gmbh-0-000, accessed 29 May 2023.

> investors. The original DOVs ran simple covered call or put selling strategies.[17]

But since then, there have been issued more sophisticated structured products. For example, *Ribbon Finance* launched a principal-protected product in August [2022], which earns yield from lending USDC deposits to market-makers such as Folkvang and Wintermute and uses a portion of the interest payments to buy weekly out-of-the-money barrier options at around 8% on the top and downside. It offers a base yield of 4% with the potential for yields of up to 13%, depending on whether the options finish in-the-money.[18]

Also, *Zerocap* launched its credit-rated crypto structured product which is a *Principal Protected Note* (PPN) which 'gives predefined exposure to an underlying asset while protecting against negative performance.[19] The structured product is a Bitcoin-

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[17] Lukas Becker, Risk.net, Crypto structured products come of age, (8 Nov. 2022), https://www.risk.net/our-take/7955057/crypto-structured-products-come-of-age, accessed 29 May 2023.

[18] Lukas Becker, Risk.net, Crypto structured products come of age, (8 Nov. 2022).

[19] Berkeley Cox, Zerocap, Introducing Crypto Structured Products with Investment Grade Credit Ratings (17 Mar. 2023)

linked PPN 'which allows investors to participate in the potential upside performance of BTC with 90% protection of their capital. The investor will participate in 60% of BTC's upside price appreciation above the Strike Level. The maximum loss for this investment is 10% of capital invested'.[20] *Zerocap* also offers *Autocallable Barrier Reverse Convertible Notes* which 'earn monthly income on the back of BTC's price movements. The notes are auto-callable because they will be redeemed early if BTC closes above the Autocall Level on an observation date.'[21]

Those product descriptions show that the crypto structured product market is using the classical structuring methods for structured product by combining a debt instrument with a sophisticated option strategies.

2. Accounting of crypto structured products

https://zerocap.com/insights/articles/zerocap-partners-with-marex/, accessed 29 May 2023.

[20] Berkeley Cox, Zerocap, Introducing Crypto Structured Products with Investment Grade Credit Ratings.

[21] Berkeley Cox, Zerocap, Introducing Crypto Structured Products with Investment Grade Credit Ratings.

ISDA observes that 'another complexity in the existing accounting model exists where companies may be required to recognize a digital asset on the balance sheet and bifurcate an embedded derivative liability to return the digital asset.'[22]

For example, in respect to crypto lending transactions, PWC observes in relation to US GAAP:

> The borrower in a crypto lending arrangement may determine that it has obtained control of the asset and would accordingly recognize the crypto asset on its balance sheet. It would also recognize an obligation to return the crypto asset to the lender. While the asset may be accounted for under ASC 350 as an intangible, the obligation to return the asset could be viewed as a hybrid instrument with a debt host contract and payments linked to the fair value of the

[22] ISDA, Accounting for Digital Assets, Key considerations (May 2022) https://www.isda.org/a/88VgE/Accounting-for-Digital-Assets-Key-Considerations.pdf (accessed 20 May 2023), 13.

> crypto assets. Accordingly, the borrower may need to assess whether *bifurcation of the embedded feature* is required under ASC 815, *Derivatives and hedging,* with specific consideration given to whether the crypto assets could be net settled.[23]

The author believes that the IASB needs to develop or refine the existing accounting standards to apply to crypto structured products to reflect the complexity of those products and the derivatives embedded in them. Hence, the author regards it as desirable if the crypto structured product is integrated for accounting purposes and measured as one instrument at fair value through profit and loss.

The author proposes that the same should apply for issuer of those crypto structured products. This would ensure that profits or losses of the structured product would be timely measured and reflected in the accounts.

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[23] PWC, Crypto assets, August 2021, 3-5, https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/crypto-assets-guide/assets/crypto9202021.pdf, accessed 29 May 2023.

3. Taxation of Structured Products

The author believes that those crypto structured products should be taxed as one instrument for tax purposes. If the accounting treatment applied an integrated approach for tax purposes, the tax treatment would simply follow the accounts to reflect a fair value accounting through profit and loss of the whole instrument. The rules of CTA 2009, ss 584 to 586 would not apply as any embedded derivative would not have to be bifurcated for accounting purposes in the first place.

4. Conclusion

Accounting and taxation of crypto structured products are far from certain as they have been around only for two years. The author believes that as soon as those structured products become more mainstream, investors and their accountings and tax advisors will have to think about how to account and tax those instruments. This article is a first step to raise awareness with the readers of the FCTC Digest what may come our way in the future, and we better are prepared.

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