

# TAXATION OF FINANCIAL INSTRUMENTS

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*Investment in securities is influenced not only by the relation between the intrinsic value and market price of the securities and between the overall yield and risk of the investment, but also by the level and method of taxation on the securities.*

With respect to the taxation of securities it is necessary to specify the following categories: investment, financial, capital, and hedging instruments, as defined in the Securities Act<sup>1</sup>. This is in accordance with European law concerning securities, including the Directive on investment services in the securities field<sup>2</sup>.

## Investment instruments

Investment instruments are objects of investment by legal or natural persons for the purpose of allocating free financial capital.

Investment instruments include:

- a) shares,
- b) bonds,
- c) unit certificates,
- d) securities issued outside the territory of the Slovak Republic which, in terms of the rights that pertain to them, are similar to the securities stated in letters a) and b),
- e) share options, interest-rate options, currency options,
- f) contracts for exchange of interest rates, currencies and shares.

## Derivative

The Securities Act defines a derivative as a financially assessable right or obligation related to an underlying security used in trading.

## Financial instrument

A financial instrument is a legal relationship from which arises a financial asset of the one contracting party and a financial obligation of the other contracting party.

## Capital instrument

A capital instrument is a residual interest in the assets of an entity after deducting all of its liabilities (for example, a share, ownership interest, unit certificate).

## Hedging instrument

The hedging instrument in an accounting entity is the derivative by which the assets or liabilities of the accounting entity (business entity) are secured.

## Investment in securities and interests

Investment in securities and interests is understood as the acquisition of them by means of:

- an investment in the share capital of a private joint-stock company or a purchase of shares on the capital market,
- an investment in the share capital of other commercial companies and cooperatives,
- a purchase of bonds, unit certificates and the like for the purposes of drawing income from the holding of the securities,
- a purchase of securities on the public market with the intention of making a profit on their resale,
- a purchase of securities, such as bills of exchange, warehouse certificates and the like, with the intention of encashing them at a profit<sup>3</sup>.

Investment in securities is typically connected with expenses and income. From the tax point of view, expenses incurred and income received are classified into two groups – either subject to, or not subject to, income tax on natural or legal persons.

Under the applicable Income Tax Act all groups of taxpayers are now paying tax at a flat rate of 19%. Significant changes have taken place in areas governing the establishing of the tax base. The tax base is the difference by which the taxable income exceeds tax expenses. In terms of substance and time, the income and expenses in the taxation period are directly stipulated by the Income Tax Act. This principle stems from the accountancy legislation. The Accountancy Act<sup>4</sup> states that accounting entities shall record facts subject to the bookkeeping in the period to which these facts relate in

<sup>1</sup> Act No. 566/2001 Coll. on securities.

<sup>2</sup> Council Directive 93/22/EEC on investment services in the securities field.

<sup>3</sup> Act No. 595/2003 Coll. on income tax.

<sup>4</sup> Act No. 431/2002 Coll. on accountancy.



terms of substance and time. The tax base is important with regard to the taxing of securities. The taxpayer is primarily interested in the level of the tax base from which he pays income tax.

The following income is not included in the tax base:

- income from the purchase of own shares for less than their nominal value and followed by a reduction in the share capital,
- exchange-rate differences related to the valuation of assets and liabilities and differences from the revaluation of derivatives and securities according to their fair value – recorded as expenses or income,
- income from the sale of securities provided that the time between their acquisition and sale exceeds three years,
- income from sale of securities where the time between the acquisition and sale of domestic securities accepted on the stock exchange, including the resale of unit certificates, does not exceed three years,
- income from the acquisition of new shares and interests, as well as the income from their exchange upon the cancellation (without liquidation) of the taxpayer; this is also true where the amalgamation into a separate accounting entity, merger or demerger of the company includes the assets of a company having its registered office in a Member State of the European Union<sup>5</sup>.

When investing in securities, the principle applies that the expenditure on the acquisition of the securities is not a tax expense at the moment the securities are acquired.

### Characteristics of income from a capital asset

The Income Tax Act precisely defines income from a capital asset. With regard to income from a capital asset, the yield ordinarily resulting from the investment of funds in financial market products is subject to tax.

According to the Income Tax Act, income from a capital asset includes the interest yield and other yields on securities. It also includes gains made at the maturity of the security from the difference between the nominal value and the issue price. In the event of early redemption of the security, the price at which the security is redeemed is used instead of the nominal value<sup>6</sup>. Other income is considered to include among other things income from the transfer of options or securities, and income from the transfer of an interest in a limited liability company or limited commercial partnership, or from the transfer of membership rights in a cooperative. The transfer of an interest in a commercial company is understood to include the transfer of a partner's ownership interest to

another partner or to another person provided that the Memorandum of Association allows for this.

An expense with regard to the income from a capital asset includes:

- the purchase price for the security or option,
- expenses related to the acquisition and sale of the security and option,
- the investment or the acquisition price of an interest in a limited liability company, limited commercial partnership, or the transfer of membership rights in a cooperative.

The tax base includes taxable income less expenses demonstrably incurred for its acquisition.

In relation to securities and investments, the Income Tax Act governs in particular:

- the tax deductibility of expenses related to investment in securities, such as investments in share capital, the acquisition of shares on the capital market, the acquisition of shares outside an organised market,
- the taxation of income from held securities, such as share dividend income, shares in investment profit, interest yields on debt securities,
- taxation of income from the sale of securities.

### Characteristics of tax expenses according to the Income Tax Act

A tax expense under the Income Tax Act is understood as an expense (cost) recorded in the bookkeeping of a taxpayer or kept in the records of a taxpayer. Since a tax expense is always set against the received income, any analysis of it must be preceded by making clear under what conditions and according to which rules the designated cost may be considered a tax expense influencing the tax base.

In order for an expense recorded in the bookkeeping to be recognized as a tax expense, the following three conditions must be fulfilled:

1. the expense (cost) must be incurred for the purpose of acquiring, securing and retaining income.
2. the expense must be duly evidenced (in accordance with the law),
3. the expense must be recorded in the accounting of the taxpayer in compliance with accounting regulations.

Where the tax expenses meet the legally prescribed requirements, the taxable income is lowered accordingly.

Tax expenses do not include for example:

- expenses for increasing the share capital, including the repayment of loans,
- expenses representing the acquisition cost of the securities and the ownership interests in a commercial company or cooperative,
- expenses for the payment of share of profits. Share of profits is paid from the profit after tax. The decision on

<sup>5</sup> Act No. 659/2004 Coll., consequentially amending Act No. 595/2003 Coll. on income tax as amended.

<sup>6</sup> Act No. 595/2003 Coll. on income tax.



its payment is taken by the competent body of the company, for example, the general meeting of shareholders in the case of the joint-stock company and the limited liability company, or, in the case of the cooperative, a meeting of the members of the cooperative. Dividends are paid to shareholders, share of profits to partners of the limited liability company, and a similar payment is made to members of the cooperative. The bonus earned by members of the board of directors and supervisory board of the joint-stock company may also be considered share of profits.

Double-entry bookkeeping procedures define the long-term and short-term assets of the entrepreneur.

Long-term financial assets are:

- shares and ownership interests,
- intercompany loans,
- long-term loans.

Short-term financial assets are:

- cash, stamps, payment orders, cheques,
- bank accounts,
- assets recorded in account group 25,
- cash in transit.

Tax expenses which are applicable only to the extent and under the conditions set out in the Income Tax Act, and in relation to the sale of securities, ownership interests and bills of exchange, comprise the following:

- a) sale of securities,
- b) sale of ownership interests and bills of exchange,
- c) assignment of receivables.

### Sale of securities

From the view of income tax, the sale of securities is closely related to accounting procedures in double-entry bookkeeping. Securities are valued at the acquisition cost, which includes purchase-related costs, for example, the charges and commissions of brokers, advisors and stock exchanges. The acquisition cost does not include interest on loans taken out for the acquisition of the security, the previously mentioned exchange-rate differences and costs related to the holding of the security. As at the date of preparation of the financial statements, securities are valued either at the market price or at a qualified estimate thereof, except for securities held until maturity and securities acquired in a direct issue and not held for trading. The market price is the price published on the local or foreign stock exchange or in another public market.

Under the Income Tax Act differences from the revaluation of the securities to the market prices, recorded as either expenses or income, are not to be included in the tax base for the respective taxation period.

Tax expenses are, according to the act, expenses representing the total acquisition costs of shares and other long-term securities for the taxation period in

which the sales occurred; the total acquisition costs may be included in tax expenses to the full amount only in the cases and under the conditions laid down by law. This total does not include bills of exchange and ownership interests.

In the case of shares accepted on the stock exchange, the acquisition cost of the shares may be included in tax expenses in the full amount provided that the acquisition cost is not more than 10% and the income from sale not less than 10% of the average price quoted by the stock exchange on the day of the purchase and sale, or, if the share was not traded on this day, of the previously quoted price. A loss on the sale of such shares shall be recognised only where the mentioned conditions have been observed. Where the stated limit of deviation has not been observed, the acquisition cost of the securities at their sale shall be recognised at the most as income from sales.

The acquisition cost of a bond is incorporated into tax expenses if the sale price is not lower than the bond yield that is included in the tax base up to either the time of sale or maturity of the bond.

Upon the sale of securities, their total acquisition costs are compared with the total income from their sale in the given taxation period. Where the taxpayer presents an overall profit from the sale of securities in the taxation period, it is not necessary to examine which securities were sold, nor the deviation from the quoted price. The total income from the sale of the securities and the total acquisition costs of the sold securities are included in the tax base in such a way that follows from the accounting procedures. In the case of a loss, it is necessary to test the observance of the 10% deviation from the average quoted price on both the day of purchase and the day of sale. For the purpose of tax-base evaluation, a loss from the respective trade will only be recognised if the permitted 10% deviation has been observed.

### Sale of ownership interests and bills of exchange

Under the law, tax expenses include expenses representing the acquisition cost of an ownership interest in a commercial company or cooperative at the time of the sale, and only up to the amount of the income from the sale. It should be noted that the investment in, purchase of, and acquisition of the interest does not from the bookkeeping point of view affect the net profit or loss. Only the sale is shown in the profit or loss of the company or cooperative and affects the tax base for this period. The law excludes from the income tax base a loss made on the sale of an ownership interest.

A bill of exchange is a debt security. The procedures for booking it in are similar to those for other securities. From the view of income tax, however, it is assessed by a different method. Regarding a bill of exchange recor-



ded as a security, the expense representing its acquisition cost at the time of sale is deemed a tax expense up to the amount of the income from the sale.

### Assigning receivables

The value of a receivable when it is assigned is also deemed a tax expense, but only up to the amount of the settlements accruing from this assignment. A loss on the sale cannot affect the tax base. In other words, the tax expense is the acquisition cost of the receivable acquired through assignment, up to the amount of the income from its settlement by the debtor, or by the assignee upon its subsequent assignment.

It should be noted in this regard that the owner of shares or ownership interests accrues income from this holding in the form of dividends or share of profits. Share income and share of profits from ownership interests are not guaranteed and their amount is determined by the size of the profit or loss of the given company.

With regard to the principle of a single taxation on income, dividends and the share of profits paid after tax by the commercial company to shareholders and partners are not subject to income tax. A partner may be a natural or legal person.

Profits are exempt from income tax where the taxpayer makes them on an ownership interest in a company based in an EU Member State and 25% of his interest in the share capital is not taxed.

### Non-tax deductible expenses in relation to securities

Tax expenses do not include expenses representing the acquisition cost of securities and ownership interests in commercial companies or cooperatives, apart from the exception mentioned in the act. When purchasing securities and ownership interests, accounting procedures are to be followed. According to accounting procedures, the acquisition cost of a security or ownership interest is not recorded in double-entry bookkeeping under the costs related to their purchase but only the under the costs related to their sale, in account 561: Securities and shares sold. During the course of the purchase, individual items related to the acquisition cost of the purchased securities and interests are recorded in account 043 – Purchase of long-term financial assets or in the case of short-term financial assets in account 259 – Purchase of short-term financial assets.

The taxation period for the taxpayer is one calendar year. The tax declaration is to be submitted by 31 March of the following year. By this date the taxpayer is required to calculate the tax from the tax base and to pay it. The taxation of income from a capital asset has been made simpler by the introduction of a flat tax. For exam-

ple, legal persons established for the purposes of business are able to have the interest yield on bonds taxed as part of the income tax base. The tax obligation may also be fulfilled by deducting the tax at source. Tax is deducted at source where it relates to:

- interest,
- yield on unit certificates, yield on deposit certificates,
- yield on bonds, money orders accruing to natural persons.

The tax base for the tax to be deducted consists of only the income for the respective taxation period. For accounts denominated in foreign currency, the tax base is determined in the foreign currency without rounding up. In the case of a beneficiary accruing securities income from an asset management company, the base for the tax that is to be deducted at source includes yields on unit certificates less that income received from the asset management company from which tax is to be deducted at source; this income includes share of profits, which is not however subject to tax.

### Taxation of securities by value-added tax

According to the VAT Act, activities concerning securities and ownership interests, including the mediation of such activities, are exempt from VAT.

The administration and safe custody of securities is not exempt from VAT.

The following types of income from securities are not deemed by the VAT Act to be taxable transactions:

- sale of securities,
- dividends,
- interest on bonds.

Also exempt from VAT are selected financial services. The VAT payer who carries out such a service may not deduct the tax according to the VAT Act and is not subject to output tax.

The following financial services are exempt from tax:

- the provision, negotiation and mediation of a loan,
- the provision, negotiation and mediation of a loan guarantee,
- activities concerning securities and ownership interests, including the mediation of such activities,
- the administration of a share fund by an asset management company in accordance with a separate regulation,
- trading for own account or for the client's account in futures contracts and options, including currency and interest-rate transactions.

The Securities Act introduced the key term "investment instruments". These include selected securities and financial derivatives that are the object of investment and trading in financial markets. Bracketed among investment instruments are those securities which are



both transferable without major administrative hurdles and fungible.

### **Transfer of securities and trading in securities for the client's account with respect to VAT**

The term "transfer of a security" is deemed by the Securities Act to include:

- paid transfer – based on a purchase agreement,
- unpaid transfer – based on a deed of gift.

A transfer irrespective of the kind of security (share, bond, bill of exchange) is exempt from tax under the VAT Act.

The term "trading in securities" was replaced with the definition of "investment services"<sup>7</sup> by the Securities Act.

The term "investment services" is closely connected with the term "investment instruments". The Securities Act defines both "principle investment services" and "supplementary investment services" with effect from 1 January 2002.

Principle investment services include:

- receipt of the client's order to purchase or sell an investment instrument and the execution of the order for another account,
- managing a portfolio of investment services in accordance with authorization from the client.

Supplementary investment services include the receipt of funds from the client and the execution of transactions in foreign-exchange assets. Trading in securities is exempt from VAT.

### **Characteristics of selected types of financial assets with respect to VAT**

#### **Ownership interest**

Activities related to ownership interests, including the mediation of such activities, are exempt from VAT under the provisions of the same act.

#### **Cash and funds in a bank account**

Under the VAT Act, the sale of banknotes and coins is deemed a supply of goods for equivalent value only where they are sold for collecting purposes for a price difference to their nominal value. Interest earned on funds in account (current accounts, time accounts) is not a taxable transaction.

#### **Financial derivatives**

Tax-exempt status also applies to trading for own

account or trading for the client's account where it concerns futures contracts and options, including exchange-rate and interest-rate transactions, executed by a bank or securities dealer.

Taxable transactions are not deemed to include financial derivative transactions, for example, the hedging of a currency risk by a business entity. Financial derivatives represent the purchase and sale of a designated valuable asset. The financial settlement does not occur immediately but at an agreed future date. The transactions are closed on options and futures exchanges, financial and foreign-exchange markets, as well as on an individual basis. The act does not precisely define the price for the above-mentioned taxable transaction, it being the yield for the respective taxation period. The VAT payer (authorised entity) shall disclose the difference between yields on financial-derivative transactions and any loss in line 07 of the VAT declaration – Supply of tax-exempt goods and services; the tax may not then be deducted under sections 28 to 41 of the act.

#### **Interests in commercial companies**

An interest in a commercial company is a measure of participation in the net commercial property of the company. The interest may be any of three forms:

- ownership interest,
- compensatory interest,
- share in the liquidation balance.

In practice ownership interests are found mainly in commercial limited liability companies. Worth noting with regard to the VAT Act is the acquisition of the interest by, for example, an investment of real property. If the company is a VAT payer, it is obliged to pay VAT from the material investment at a rate of 19%.

A compensatory interest is not subject to either income tax or VAT.

A share in the liquidation balance is not subject to either income tax or VAT.

### **Summary**

With regard to the taxation of income from a capital asset, substantial changes were introduced by the new Income Tax Act that entered into force on 1 January 2004. The changes stem from one of the act's basic principles, the principle of a single taxation of income – meaning that the income from a capital asset is to be taxed only once.

*(This contribution is a result of research task G-153/05 – Theoretical Approaches to the Evaluation of Financial Instruments in Developed Financial Markets and the Possibilities for their Application under Slovakia's Conditions.)*

<sup>7</sup> Act No. 566/2001 Coll. on securities.