

# BEPS ACTION PLAN 2 - A NEW ERA FOR TAX TREATMENT OF HYBRID INSTRUMENTS

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## Introduction

This article provides a general overview on the present factors that determine the tax treatment of hybrid financial instruments and a discussion on how the Organisation for Economic Co-operation and Development's ("OECD") recommendation under the Base Erosion and Profit Shifting ("BEPS") Action Plan 2 may alter the way hybrid instruments are treated for tax purposes in Singapore.

## Hybrid financial instruments and the tax conundrum

Hybrid financial instruments, such as redeemable preference shares or convertible bonds, are a cause of contention and uncertainty in terms of their tax treatment.

Distinct from traditional forms of financial instruments, hybrid financial instruments exhibit both debt and equity-like features, raising concerns on which side of the debt/equity dichotomy that the Inland Revenue Authority of Singapore ("IRAS") would classify the instrument for tax purposes.

This distinction may be significant for both issuers and investors alike, as it determines the deductibility and taxability of distributions from such instruments. The table below shows the potential tax implications for issuers and investors:

Classification by IRAS	Issuer	Investor
Debt	If conditions for deductibility are met, distributions on the instrument are tax deductible.	Unless specifically exempted from tax, distributions on the instrument are taxable.
Equity	Distributions on the instrument are not tax deductible.	Dividend is generally exempted from tax unless it is a foreign dividend that does not qualify for exemption.

**At present, there are no specific provisions in the Income Tax Act ("ITA") that stipulate the considerations or factors in determining the nature of a hybrid instrument (i.e. whether it is classified as debt or equity). Present methods for classification**

On 19 May 2014, IRAS published an e-tax guide on "Income Tax Treatment of Hybrid Instruments", illustrating the approach in determining the nature of the instrument for tax purposes.

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## **IRAS' two-stage approach**

Rather than following the accounting approach in classifying hybrid instruments, IRAS has made clear that the accounting treatment will not determine the characterisation of the hybrid instrument for tax purposes.

Instead, IRAS elects to approach the task with a two-stage approach:

- **Stage 1:** The legal form of the hybrid instrument is determined; this is done by examining the legal rights and obligations created by the instrument. For example, the hybrid instrument would generally be characterised as equity if the legal terms of the instrument indicate ownership interests in the issuer; and
- **Stage 2:** Where the legal form of the instrument is not indicative or reflective of the legal rights and obligations, facts and circumstances surrounding the instrument and a combination of factors will be examined.

## **Relevant factors for Stage 2 analysis**

In its e-tax guide, IRAS lists a range of non-exhaustive factors which are summarised in the table below:

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Factors to consider	Debt	Equity
Nature of interest acquired (eg. Shareholding and residual interest in the issuer)		×
Right to participate in issuer's business		×
Voting rights conferred by the instrument		×
Obligation to repay the principal amount (eg. Fixed repayment date and where repayment is not conditional upon the issuer's business performance)	×	
Payout (eg. Cumulative distributions and where payment is not conditional upon the issuer's business performance)	×	
Investor's right to enforce payment (eg. Where the investor has an unconditional right to enforce payment of distribution and repayment of principal amount)	×	
Classification by other regulatory authority (eg. Other regulatory authorities regard the instrument as a debt)	×	
Ranking for repayment in the event of liquidation or dissolution (eg. Where the right of the investor to repayment of principal is subordinated to that of general creditors)		×

It is also expressly stated that the presence of any single factor does not necessarily in itself lead to the classification as either debt or equity; all factors are taken into consideration.

### Advanced tax ruling

From the issuer's point of view, given the lack of a definitive position by IRAS, it may be advisable for Singapore-based issuers to seek an advanced tax ruling on the anticipated characterisation by IRAS. Where a ruling is obtained from IRAS, the issuer is required to communicate this to investors or prospective investors through appropriate channels such as the offering circular or on their website.

### Foreign-based issuers of hybrid instruments

In relation to the classification of hybrid instruments issued by a foreign-based issuer, IRAS has expressed that it would apply a similar approach to the above.

Additionally, IRAS has stated that it would take into account the classification of the instrument in the

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country of the issuer. This approach appears to be influenced by the OECD's recommendations under BEPS Action Plan 2 to address mismatches in the tax treatment of hybrid instruments across jurisdictions. However, IRAS' approach falls shy of full compliance with the recommendations under BEPS Action Plan 2, which will be further explained below.

## **BEPS Action Plan 2**

Given that there is no international consensus on the tax treatment of hybrid instruments, it is possible for corporations to take advantage of hybrid mismatch arrangements; arrangements that exploit differences in the tax treatment of an instrument under the laws of two or more tax jurisdictions to achieve results such as double nontaxation.

BEPS Action Plan 2 seeks to target such hybrid mismatch arrangements. Action Plan 2 sets out recommendations for rules to address mismatches in tax outcomes where they arise in respect of payments made under a hybrid financial instrument or payments made to or by a hybrid entity.

In brief, the recommendations take the form of linking rules that align the tax treatment of an instrument with the tax treatment in the counterparty jurisdiction. The proposed rules would apply automatically and there is an order of rules in the form of a primary rule and a secondary rule.

### **The primary and secondary rule**

The primary rule is that countries deny the taxpayer's deduction for a payment to the extent that it is not included in the taxable income of the recipient in the counterparty jurisdiction or to the extent it is also deductible in the counterparty jurisdiction.

If the primary rule is not applied, then the counterparty jurisdiction can generally apply a secondary rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch.

However, it must be emphasised that the coordination rules only address the mismatches in tax outcomes in respect of payments made under the hybrid instrument without affecting the commercial outcomes. As to whether the hybrid instrument is classified as debt or equity for tax purposes, it appears that this remains determinable by the respective domestic laws of the jurisdiction.

## **Implications on the present IRAS approach**

As alluded to above, the present IRAS approach does not incorporate the primary and secondary rule approach as recommended under BEPS Action Plan 2. IRAS' approach is focused on the factors identified earlier and it is noteworthy that the classification in another jurisdiction is merely a factor and not in itself conclusive of the tax outcome in Singapore. As a result, double nontaxation remains a possibility based on the present rules.

A few noteworthy considerations must be pointed out before further discussion:

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- the IRAS e-tax guide was published before the release of the final report of BEPS Action Plan 2;
- the recommendations under BEPS Action Plan 2 are drafted to only address mismatches in tax outcomes, the classification issue of debt/ equity still appear to be based on respective domestic laws; and
- Singapore has not expressed its intention to adopt all of the BEPS Action Plans, including Action Plan 2.

## Conclusion

It is uncertain whether Singapore will act upon BEPS Action Plan 2 or introduce substantial change to its present regime any time soon. As such, it may be prudent to review multi-jurisdictional hybrid instruments to examine how they will be treated in both payer and payee jurisdictions, particularly if the counterpart jurisdiction has adopted the BEPS Action Plan 2 steps in a substantive way.

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