Introduction 1

1.1 Motivation

The current, extremely volatile financial and economic environment poses many challenges to most taxpayers. Dealing with external funding may be one of these challenges, also because funding from third parties has become much stricter and seldom in the form of pure debt capital, i.e. loans, and of pure equity capital, i.e. ordinary shares. Rather, and also due to a variety of other non-tax reasons, instruments for finance and investment have become numerous and more complex, mostly combining elements of both worlds, the so-called hybrid financial instruments. Their spectrum ranges from shares with features typical for loans (e.g. redeemable preference shares) to loans with features typical of ordinary shares (e.g. profit-participating loans). Together with the increasing globalization of the world economy, financial markets have undergone a process of internationalization. The increasing integration between financial markets, and the resulting opening to cross-border capital flows, are illustrated in a constant increase of the number of and in the level of sophistication in the structuring of cross-border financial transactions. They are accompanied by, as well as made possible due to, institutional developments, e.g. deregulation, and by diversifications in market participants, e.g. participants of cross-border mergers and acquisitions.

In spite of the enormous diversity of financial instruments, the current taxation of hybrid financial instruments and the remuneration derived therefrom is basically accompanied by a neat division into dividend-generating equity and interest-generating debt. In principle, this division is decisive because, on the one side, the return on equity capital is not tax deductible at the level of the dividend-paying incorporated capital borrower, but, in contrast, is tax exempt at the level of the dividend-receiving incorporated capital lender. On the other side, the return on debt capital is tax deductible at the level of the incorporated capital borrower, but subject to tax at the level of the incorporated capital lender.

Further, this issue can be extended on an international dimension with both parties residing in different countries. International corporate taxation involves two

S.-E. Bärsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*,
DOI 10.1007/978-3-642-32457-4_1, © Springer-Verlag Berlin Heidelberg 2012

basic principles: the single tax principle and the benefit tax principle. Based on the latter one, in a converging world, return on equity capital is usually only subject to tax in the source country (corporate income tax and withholding tax), i.e. where the profit-distributing corporation is resident, while return on debt capital is normally only subject to tax in the residence country (corporate income tax and commonly no or minor withholding taxes, but which can be credited in the residence country, in the source country), i.e. where the interest-receiving corporation is resident. Hence, the tax classification as interest-generating debt or dividend-generating equity is crucial for the allocation of taxing rights.

Additionally and based on the single tax principle, return on cross-border financial transactions should be taxed solely once, neither more nor less. Thus, international double taxation as well as non- and minor-taxation must be avoided. Based on the distinction between debt and equity capital for tax purposes and the involvement of more than one tax jurisdiction, different tax classifications of hybrid financial instruments and the remuneration derived therefrom under the respective (domestic) tax rules in the involved countries may distort this single tax principle. Hence, the provisions concerning these tax classifications are crucial. Considering the broad diversity of hybrid financial instruments and the vast number of their characteristics and features derived from both pure debt capital and pure equity capital, the unambiguous existence of the same tax classification of any hybrid financial instrument in both the source country and the residence country is challenging.

When putting things straight – the distinction between interest-generating debt and dividend-generating equity and their different tax treatments, the diverging allocation of taxing rights, and the all but impossible uniform tax classification of hybrid financial instruments – the tax classification of hybrid financial instruments and the remuneration derived therefrom is highly important for the corporate tax burden. This leads to both tax planning opportunities and tax risks for corporations. In contrast, from a tax systematic perspective, the avoidance of both is of great interest. This is particularly important for the functioning of the internal market which shall be established within the European Union and which is defined as an area without internal frontiers ensuring the free movement of capital, goods, persons and services. With respect to hybrid financial instruments, their tax classification faces 27 different national tax systems within the EU and even more within the OECD as well as, further, some EU Directives and a sheer number of bilateral income tax treaties. Considering the above-mentioned issues, market participants are therefore confronted with competitive disadvantages. Such restrictions do not comply with the idea of an internal market. Although this issue is not new, and several initiatives to coordinate or even harmonize corporate tax systems in particular within the EU, but also within the OECD, have stressed the necessity to eliminate taxation differences (most recently, for instance, by the 'Monti' report),[1] these initiatives were only partially followed by policy action.

[1] Cf. Monti 2010: 79 et seq.

Although no comprehensive data on the tax amounts at stake in case of different tax classifications of hybrid financial instruments exists,[2] this issue is well known to economists, policy makers and tax experts. However, probably because of the complexity of the tax rules concerning hybrid financial instruments and the remuneration derived therefrom, there are only few systematic analyses. If existent, these analyses are oftentimes limited to a pure national context and/or to the domestic tax rules of a single country; such examinations were, for instance, undertaken by *Abbey*, *Brandsma*, *Bourke*, *Briesemeister*, *Cooper*, *Jansen/van Kasteren*, *Krause*, *Lühn*, *Serbini/Flora* and *van Strien*.[3] Furthermore, some investigations focus mainly only on a general level of income tax treaties (*Avery Jones et al.*, *Eberhartinger/Six*, *Lang*, *Pijl*, *Rotondaro*, *Schuch* and *Six*)[4] and/or EU Directives (*Bundgaard*, *Eberhartinger/Six* and *Helminen*).[5] Besides, some investigations are not limited to the domestic tax rules of a single country and/or a general level of income tax treaties, but extend to comparative analyses which are particularly undertaken by *Duncan/IFA*, *Haun*, *Schön et al.* and *Six*. However, from these, only *Haun* and *Six* examine on this basis hybrid financial instruments in a cross-border context,[6] while other analyses in this context are limited to a more abstract level (*Blessing*)[7] or to individual non-systematic cases (e.g. *Bogenschütz*).[8] Moreover, convincing options for reform in this context within the dichotomous debt-equity framework, and either within the coexistence of source-based and residence-based taxation or those that depart therefrom, are rare (*Benshalom*)[9] and have not yet been elaborated on the basis of a comparative analysis or are mainly limited to a merely abstract level (*EU Code of Conduct Group*, *OECD* and *Wood*).[10] In these contexts, moreover, no comprehensive, in-depth examinations were carried out containing the currently applicable corporate taxation of hybrid financial instruments and the remuneration derived therefrom which included a comparative analysis of the four – in cross-border financing activities important – EU/OECD Member States Australia, Germany, Italy and the Netherlands. The contribution of this thesis is to fill this gap.

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[2] Cf. also OECD 2012: 5.

[3] Cf. Brandsma 2003b; Cooper 2003; Abbey 2004; Bourke 2004; Serbini and Flora 2005; Briesemeister 2006; Krause 2006; Lühn 2006a; van Strien 2006; Jansen and van Kasteren 2008.

[4] Cf. Lang 1991; Rotondaro 2000; Schuch 2004; Avery Jones et al. 2009; Eberhartinger and Six 2009; Six 2009; Pijl 2011.

[5] Cf. Helminen 2000; Eberhartinger and Six 2007, 2009; Bundgaard 2010a, b.

[6] Cf. Haun 1996; Duncan 2000; Schön et al. 2009; Six 2008.

[7] Cf. Blessing 2012.

[8] Cf. Bogenschütz 2008a.

[9] Cf. Benshalom 2010.

[10] Cf. Wood 1999; Code of Conduct Subgroup 2010; OECD 2012. However, options for reform that depart from the dichotomous debt-equity framework are numerous. See, instead of many others, de Mooij and Devereux 2011.

1.2 Objective

Against this background, and under the given coexistence of source-based and residence-based taxation and the different tax treatment of interest-generating debt and dividend-generating equity, the main objective of this thesis is to elaborate a tax classification of hybrid financial instruments and the remuneration derived therefrom which is both compliant with guiding tax principles and not in conflict with economic arguments, and supported by findings of a comparative analysis. Furthermore, alternative approaches and options that depart from the general coexistence of source-based and residence-based taxation and/or the different tax treatment of interest-generating debt and dividend-generating equity shall be identified as well.

In order to do so, the interdisciplinary background of hybrid financial instruments has to be assessed first. The objective is to explain what hybrid financial instruments are, the extent to which they influence or are influenced by the environment from an economic and legal perspective, and the general tax consequences of the remuneration derived from financial instruments. Second, guiding tax principles are elaborated and put in more precise terms with regard to the corporate taxation of hybrid financial instruments in a cross-border context. The widely accepted principles used here are efficiency and neutrality, equity among taxpayers and nations, EU law as well as aspects of administration and compliance costs. Furthermore, a characteristic-based classification framework of financial instruments is developed for the systematic examination in the further assessment of both currently applicable and prospective tax classifications. Third, and with the application of this framework, the relevant tax rules currently applied by Australia, Germany, Italy and the Netherlands regarding the corporate taxation of hybrid financial instruments and the remuneration derived therefrom are in detail demonstrated and comparatively analyzed. Next, and based on these findings, selected hybrid financial instruments actually leading to different tax classifications are identified. This results in tax classification conflicts which are, further, critically assessed against the guiding tax principles. This in-depth analysis aims to highlight the main deficits of the currently applicable tax classifications of hybrid financial instruments that justify the necessity of a reform. Finally, options for such reform are developed and evaluated, which are at least compliant with the guiding tax principles.

Due to the high degree of complexity of this topic, certain limitations are made. First, the scope of this thesis centers on hybrid financial instruments issued and held by corporations, while individuals as well as transparent tax entities are disregarded. Consistent with this limitation, this applies also for investment funds and permanent establishments which are therefore not covered by this thesis. These exclusions allow for the focus on corporate income taxation, possible local taxes and withholding taxes. Hereby, another, extremely relevant issue is intra-group financing. To the extent that intra-group financing has to build on the same reliable analysis of hybrid financial instruments as external capital lender, both are discussed. But, if and so far as a different taxation of corporate shareholders as internal capital lender applies and/or could make sense, intra-group financing remains to a large extent beyond the scope of this thesis. In particular, thin capitalization rules and earning stripping rules restricting the tax deductibility of interest payments at the level of the capital borrower have an impact on intra-group financing. Despite the recent trend of spreading out such techniques, the effects of these rules will be disregarded for the purpose of the further analysis as they are not directly significant for the fundamental tax issues of hybrid financial instruments, but for all forms of external funding. Finally, issues concerning the timing with regard to the moment when remuneration payments on hybrid financial instruments are recognized as taxable income, the valuation and the non-current taxation will be disregarded as they are also not immediately relevant for the demonstration of the issues in terms of tax classifications of hybrid financial instruments. For the question concerning the valuation, the assumption is made that the arm's length principle is followed. Further, no general anti-avoidance rules are applicable.

1.3 Structure

The thesis is divided into six chapters. Chapter 2 deals with the interdisciplinary background of hybrid financial instruments. In order to do so, a description of hybrid financial instruments is presented in a first step. These facts provide in a second step the basis for the corporate finance theories and practices explaining the presence of different financial instruments. It is worthwhile to offer in advance an image of what today's international financial markets actually are as well as the extent and the relevance of hybrid financial instruments within these markets. After, the general relevance of different financial instruments in the fields of financial accounting and banking regulatory law will be presented. The final step covers fundamental principles of corporate taxation in terms of financial instruments. In particular, the functions of corporate income taxes, the prevailing dichotomy of debt and equity capital in tax policies and, hereby, the two principles of residence-based and source-based taxation are presented. These elaborations are underlined by the assessment of the respective country practices of the EEA/EU/OECD Member States.

In Chap. 3, the focus is shifted to the elaboration of guidelines for corporate income taxation of hybrid financial instruments. First, guiding tax principles are evolved and put in more precise terms with regard to the taxation of financial instruments. These principles are used for the evaluation of the taxation currently applied by selected EU/OECD Member States to such instruments and for the design of reform options. Fundamental criteria commonly accepted by economists and tax experts considered here are efficiency and neutrality as well as equity with respect to taxpayers and nations, both from a national and, in particular, international perspective. In this context, the impact of EU law is also outlined. Moreover, administration and compliance costs are taken into account. Second, a framework for the classification of hybrid financial instruments is evolved. This framework is based on the distinctive characteristics of financial instruments which originate from the different legal rights and obligations underlying these instruments. These characteristics are used for the systematic identification of the tax classifications currently applied by selected EU/OECD Member States. Moreover, the consequentially decisive characteristics as well as the highlighting of ideal-typical characteristics of pure debt capital and pure equity capital are supportive for the design of reform options.

In subsequent chapters, the focus is shifted to taxation issues. The description, comparison and evaluation of the tax classifications and tax treatments of hybrid financial instruments and the remuneration derived therefrom with respect to Australia, Germany, Italy and the Netherlands are carried out along two chapters. The selection of these EU and/or OECD Member States is based on their importance in cross-border financing activities and for attracting capital from and providing capital to the international financial markets. These chapters, including the elaboration of options for reform, serve as the pillars of this thesis.

The first part demonstrates and comparatively analyzes the currently applicable tax classifications and tax treatments of hybrid financial instruments and the remuneration derived therefrom in Chap. 4. In a first step, however, general remarks are firstly given on possible classification techniques for tax purposes, including references to classifications for other purposes, in both domestic and cross-border contexts. The second step examines the currently applicable tax classifications and treatments of hybrid financial instruments by Australia, Germany, Italy and the Netherlands. This in-depth examination focuses on domestic tax provisions which are prefaced by an abstract of the relevant company law provisions. Apart from the domestic tax law, bilateral income tax treaties and EU Directives will be discussed as well, both in a general way and in a specific way with respect to the four examined countries. In the final step, the afore-elaborated tax classifications are comparatively analyzed. Hereby, the focus is on the demonstration of the differently decisive characteristics which centers on financial rights and obligations.

The second part firstly uncovers mismatches due to the different tax classifications of the remuneration derived from hybrid financial instruments in Chap. 5. These actual tax classification conflicts are caused by a significant lack of consistency in the currently applicable tax classifications between the examined countries. On the basis of two exemplary, in practice highly relevant hybrid financial instruments – preference shares and profit-participating debt instruments – the risk of international double taxation and minor-/non-taxation will be systematically pointed out and illustrated by in-depth synopses. After, these risks will be briefly assessed against the guiding tax principles and, based on these findings, the necessity of tax reforms is presented. At the end of Chap. 5, options for reform of the taxation of hybrid financial instruments and the remuneration derived therefrom, that are both appropriate to achieve the previously identified guiding tax principles and not in conflict with economic arguments and basically in accordance with the findings of the comparative analysis, are outlined and evaluated. In a first step, options for reform within the dichotomous debt-equity framework and the general coexistence of source-based and residence-based taxation by coordinating the domestic tax classifications are in the focus. For this purpose, a distinction is made between harmonized and non-harmonized domestic tax classifications. The second step examines options for reform that depart from the general coexistence of source-based and residence-based taxation by enhancing and/or diminishing the source-based and/or residence-based taxation. In the final step, options for reform that fully depart from both the dichotomous debt-equity framework and the coexistence of source-based and residence-based taxation are briefly presented.

The final chapter offers a summary of the main findings.

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Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context
Issues and Options for Reform
Bärsch, S.-E.
2012, XXII, 390 p., Hardcover
ISBN: 978-3-642-32456-7