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Income tax treatment of hybrid instruments in Singapore

The Inland Revenue Authority of Singapore (IRAS) recently issued guidance on the income tax treatment of hybrid instruments in Singapore (the Guide). Prior to this guidance, there have been no specific provisions in the Singapore *Income Tax Act* (ITA) on the character of hybrid instruments for tax purposes (i.e. whether a hybrid instrument is debt or equity for tax purposes).

The one exception is the 2014 Singapore budget amendment to treat Basel III Additional Tier 1 (AT1) capital instruments (other than shares) issued by specified Singapore-incorporated banks and their holding companies as debt for tax purposes.

IRAS Guide: Income tax treatment of hybrid instruments

Briefly, where the legal form of a hybrid instrument issued by a Singapore-based issuer is not indicative of the legal rights and obligations, IRAS will adopt a 'combination of factors' approach to determine the tax treatment of an instrument. Under this approach, the characteristics of a hybrid instrument are examined and considered in entirety.

Factors considered by the IRAS (with the debt/equity inference in parenthesis) include:

- Investor acquires a shareholding and residual interest in the issuer (equity)
- Investor acquires a right to participate in the issuer's business (equity)
- Instrument confers the investor with voting rights (equity)
- There is a fixed repayment date in a reasonably foreseeable future and repayment is not conditional on business performance of the issuer (debt)
- There is no fixed repayment date, although there is incentive for the issuer to redeem the instrument, such as a step-up feature (debt)
- Distributions are cumulative and payment is not conditional on business performance (debt)
- Investor has an unconditional right to enforce the payment of a distribution and repayment of the principal amount (debt)
- Relevant regulatory authorities in Singapore regard the hybrid instrument as debt (debt)
- The right of the investor to repayment of principal is subordinated to that of the general creditors or to the holder of subordinated debt of the issuer (equity)
- The investor is required to bear current or future losses of the issuer by way of either a write-down of the principal amount of the instrument or conversion to ordinary shares of the issuer (equity).

The Guide does not discuss the weight allocated to each factor, nor the tax treatment of instruments that have already been issued in the Singaporean market (e.g. perpetual securities). However, without the recent budget change to the treatment of AT1 capital issued by a local Singapore bank, such an instrument should be expected to be equity based on the above tests.

To characterise a hybrid instrument issued by a foreign-based issuer, IRAS will examine the above factors. IRAS notes in the Guide that it will also consider the characterisation of the instrument in the country of the foreign issuer and that "*the use of this guide may be limited by new forms of hybrid instruments as well as changes in tax treatments adopted by foreign tax jurisdictions which may have an impact on the Singapore income tax consequences*".

In doing so, IRAS is seeking to address potential mismatches in the tax treatment of hybrid instruments across jurisdictions.

The position articulated by IRAS in the Guide is not the law and taxpayers may appeal to the courts if they do not agree with IRAS' position. For taxpayers that require certainty, an advance ruling may be sought from IRAS.

Income tax treatment of Basel III AT1 instruments

Broadly speaking, AT1 capital instruments, other than shares, issued by specified Singapore banks and their holding companies will be treated as debt for income tax purposes with effect from the 2015 year of assessment (i.e. from 1 January, 2014). Distributions on these instruments will be tax deductible. Tier 2 instruments, other than shares, are currently regarded as debt for tax purposes and will continue to be regarded as debt.

This treatment does not extend to AT1 instruments issued by Singapore branches of foreign banks. These branches are not required to comply with *MAS Notice 637*, which is issued to banks incorporated in Singapore and sets out directives on their risk-based capital adequacy requirements. As such, hybrid instruments issued by these branches are likely to be subject to the 'combination of factors' approach discussed above.

> This may lead to a scenario where hybrid instruments with materially similar terms and conditions have different tax treatments based on the status of the issuer.

Other developments

A new section 14X is to be introduced into the ITA (via *Income Tax (Amendment) Bill 2014*). The proposed section 14X provides for the deduction of expenditure incurred by a person for the purpose of complying with any local or foreign legal or regulatory requirements, if the expenditure is not capital in nature and is incurred for the purpose of any business from which the person's income is acquired. The new section 14X will apply from the 2014 year of assessment.

The Murray Inquiry's interim report

The Murray Inquiry has reviewed the Wallis framework for the financial system and assessed how well it is suited to current economic conditions, taking into account the lessons from the global financial crisis. The challenge for the Murray Inquiry is to develop a framework that has a 10 to 15 year vision for financial services, given trends in technology, globalisation and ageing.

The Murray Inquiry's interim report is a wide ranging review covering a number of issues. Major takeaways are:

- Competition is the cornerstone (i.e. a level playing field)
- Disclosure is not sufficient (due to complexity, conflicted advice and consumer disengagement)
- Financial services are global (so shocks to the market can come from anywhere).

A number of matters have not been addressed, including:

- Future scenarios, such as:
  - Changes in the boundaries of financial services
  - New business models
  - New entrants
  - Advances in technology
- Wallis – what worked and what didn't
- Global regulations.

The interim report presented 136 policy options and is unlikely to follow through on all of them.

However, if it carries through on some of the policy options, there is potential for seismic shifts in Australia's financial services landscape.

Taxation observations

The interim report did not make any recommendations for tax changes. However, it did make a series of observations on aspects of the current taxation system which could affect the efficient allocation of capital in the financial system.

The interim report flags the potential removal of interest withholding tax on all foreign funding of Australian banks. It is not as clear whether removing withholding tax from interest on debt funding provided by the foreign head office of Australian bank branches is supported.

The interim report suggests support for removing the current cap on tax deductions for interest on funding of local branches of foreign banks.

It also notes that the current application of withholding tax arising from clearing derivatives through a central clearing party is putting Australia at a competitive disadvantage.

There are no recommendations for change that address the distortive effects of GST not being levied on most financial services. Given recent political debate and lack of interest in any changes to the GST (most notably raising the GST rate), it is questionable whether this aspect of the interim report will progress.

The interim report suggests that the imputation system affects investment decisions between debt and equity capital in Australia. However, no recommendations are made for modifications to the imputation system to encourage offshore expansion by Australian companies, while still encouraging those companies to remain domiciled in Australia. The interim report did not discuss previous imputation reform suggestions such as allowing streaming of franked income to residents (only a partial solution), or allowing imputations credits for foreign tax paid. These matters should be addressed in the final report or, more likely, in the Taxation White Paper.

Impact of company tax rate reduction and paid parental leave levy on capital management

In the lead up to 1 July 2015, three coinciding factors will require additional consideration be given to the franking account balances of companies to ensure that shareholder value is maximised.

1. The corporate tax rate is expected to be reduced from 30% to 28.5%
2. 'Large' companies are expected to be required to pay a paid parental leave (PPL) levy at a rate of 1.5%
3. Currently, it is not expected that there will be any transitional or consequential amendments made to the dividend imputation system for these changes (but this should be monitored).

Based on the limited detail contained in the Coalition's pre-election policy document, the PPL levy is expected to:

- Apply to companies with taxable income in excess of $5 million, and only to the portion above that amount
- Be non-deductible
- Not generate franking credits.

As a result, the after-tax profits of a large company will not change, even though the corporate tax rate has been reduced.

A simple example of this is illustrated below (assuming pre-tax profits equals taxable income):

	Prior to 30 June 2015	From 1 July 2015
Pre-tax profits	100	100
Company income tax	30	28.5
PPL levy	0	1.5
After tax profits	70	70
Franking credits	30	28.5
Maximum franking amount on a $70 dividend	30	27.9

As a result of the corporate tax rate reduction, the maximum franking amount for a dividend is likely to be reduced from 1 July 2015. The maximum franking amount is calculated under section 202-60 of the *Income Tax Assessment Act 1997* (ITAA97) as the amount of the distribution x (corporate tax rate/1-corporate tax rate). So, a dividend of $70 currently has a maximum franking amount of $30. From 1 July 2015, the maximum franking amount would reduce to $27.90 for the same $70 dividend. This will result in 'trapped' franking credits. In other words, fewer franking credits will be distributed for the benefit of shareholders when a dividend is paid, reducing the after-tax cash position of a shareholder.

No transitional or consequential amendments to the dividend imputation system have been indicated. By contrast, when New Zealand recently reduced its corporate tax rate, it introduced transitional provisions to allow franking credits generated at the previous corporate tax rate to be distributed at that rate for a period after the corporate tax rate was reduced. The equivalent response in Australia would be an amendment to section 202-60 of the ITAA97.

On an ongoing basis, trapped franking credits may arise as the PPL levy will reduce profits but will not generate franking credits.

Separately, the appropriate treatment of the PPL levy for financial statement purposes should be considered.

In the absence of transitional provisions at 30 June 2015, and on an ongoing basis, companies will need to consider how best to manage their franking account balances in the interests of shareholders.

In some cases, it is expected that companies could consider special dividends or other capital management strategies, such as share buy-backs, to distribute franking credits prior to 1 July 2015. On the other hand, companies wholly owned by non-residents may consider deferring dividend distributions until after 1 July 2015.

In order to maximise share price, shareholder value and after-tax cash for shareholders, companies will need to monitor current and forecast franking account balances and distributable profits, having regard to profit forecasts, expected tax payments and scheduled distributions.

Taxation on conversion of Basel III compliant tier 2 subordinated debt

Prudential Standard *APS 111 Capital Adequacy: Measurement of Capital* (APS 111) requires that Additional Tier 1 (AT1) and Tier 2 (T2) capital instruments must be written-off or converted to ordinary shares if relevant loss absorption or non-viability provisions are triggered. Further, APS 111 requires that the maximum number of ordinary shares issued on conversion cannot exceed the price of the T2 capital instrument at the time of issue divided by a percentage of the issuer's ordinary share price at that time.

The tax implications upon conversion of a T2 capital instrument into ordinary shares in the event that a non-viability provision is triggered, are less than clear.

There are differing views on the application of the commercial debt forgiveness (CDF) provisions in circumstances where the conversion would result in a prima facie gain to the issuer of the debt due to the cap on the number of ordinary shares that can be issued on conversion.

Section 245-35 of the *Income Tax Assessment Act 1997* (ITAA97) states that a debt is forgiven if *"the debtor's obligation to pay the debt is released or waived, or is otherwise extinguished other than by repaying the debt in full"*.

Section 245-37 of the ITAA97 states that: *"If an entity subscribes for shares in a company to enable the company to make a payment in or towards the discharge of a debt it owes to the entity, the debt is forgiven when, and to the extent that, the company applies any of the money subscribed in or towards payment of the debt"*.

Essentially, the difference in views comes down to whether a debt/equity swap is within the general CDF definition, which the Explanatory Memorandum to the original Bill appears to contemplate and, if it isn't, whether the ordering of transactions is critical to the operation of the specific CDF debt/equity swap provision.

One view is that a debt/equity swap was intended to be included in the general definition of CDF, and that the specific CDF debt/equity swap provision was included to apply where the timing of transactions was thought to be critical to the operation of the CDF provisions.

Assuming a debt/equity swap is not included in the general definition of CDF, the alternative view is that, if the ordering of transactions is critical to the operation of the CDF debt/equity swap provision, extinguishing a pre-existing debt in return for the allotment of shares should not give rise to a CDF.

Financial institutions tend to prefer conversion of a T2 debt into ordinary shares rather than a write-off in the event of a non-viability trigger. The preference is, in part, due to the tax uncertainty created by the interaction of the CDF provisions and the taxation of financial arrangement provisions. However, as outlined above, conversion of the debt into ordinary shares has its own uncertainties.

OECD global model of automatic exchange of financial account information commentaries released

On 21 July 2014, the Organisation for Economic Co-operation and Development (OECD) released the first edition of the *Standard for Automatic Exchange of Financial Account Information in Tax Matters*. The document contains the Model Competent Authority Agreement (Model CAA), the Common Reporting Standard (CRS) and commentaries interpreting each section of the Model CAA and the CRS. It also includes seven Annexes containing model agreements, the CRS user guide and other documents.

The CRS draws extensively on the U.S. FATCA intergovernmental agreements (IGAs). However, the requirements for financial institutions (FIs) in countries that adopt the Model CAA (signatory countries) have been modified to reflect the multilateral nature of the CRS and to focus on tax residency.

Therefore, FIs in signatory countries will need to modify their FATCA programs to ensure compliance with the CRS documentation, due diligence and reporting requirements.

Global model of automatic exchange of financial account information

The global model of automatic exchange of financial account information is based upon countries signing either a bilateral or a multilateral Model CAA. This provides the terms and conditions for the exchange of financial account information and the translation of the CRS into domestic law.

Model CAA

The Model CAA contains the type of information to be exchanged between signatory countries, the time and manner of exchange of financial account information, the requirement to collaborate on compliance, the enforcement requirements, as well as the confidentiality and safeguards that must be respected by the signatory countries.

The exchange of information required to be reported under the reporting and due diligence rules of the CRS can be done on an annual basis, or more frequently, using the information technology modalities described in the commentary to the Model CAA.

Safeguards to ensure the confidentiality of the information received include the legal framework required, practices and procedures for information security management, as well as compliance and sanctions to address a breach of confidentiality. These are described in detail in the commentary to the Model CAA.

To ensure compliance by signatory countries, a competent authority can suspend the CAA if there is significant non-compliance by another competent authority.

CRS

The CRS contains the documentation, due diligence and reporting standards to be implemented by FIs in signatory countries (reporting FIs). The general requirements are based on Annex I of the FATCA Model 1 IGA. However, there are significant differences, including:

- **Scope of reporting FIs** – Certain FIs that are treated as non-reporting FIs for FATCA are not similarly treated in the CRS. However, the CRS does allow the domestic law of a jurisdiction to treat low-risk entities as non-reporting FIs
- **General reporting requirements** – Similar to the FATCA Model 1 IGA, FIs will be required to report information on 'Reportable Accounts' (i.e. accounts held by individuals and entities that are 'Reportable Persons' and 'Passive Non-Financial Entities' (Passive NFEs) with 'Controlling Persons' that are Reportable Persons). However, the reporting requirements are based on the tax residency of the Reportable Person
- **General documentation and due diligence requirements** – Similar to Annex 1 of the FATCA Model 1 IGA, CRS describes due diligence procedures for 'New Accounts' and 'Preexisting Accounts' held by individuals and entities. However, there are significant modifications in the approach, such as differences in thresholds for account review and greater focus on residency (and elimination of references to citizenship). The system relies on FIs obtaining a 'self-certification' to determine the residency of an account holder and the commentary specifies the content of the self-certification. The U.S. W-8 or W-9 forms would generally not be acceptable for CRS purposes outside of the U.S.
- **Effective implementation** – Jurisdictions are expected to include specific provisions in their domestic legislation to impose sanctions for false self-certifications. In addition, jurisdictions are required to implement administrative procedures: (i) to verify the compliance of FIs with the reporting and due diligence procedures; (ii) to follow up with an FI when undocumented accounts are reported; and (iii) to ensure that entities defined as 'Non-Reporting Financial Institutions' and accounts defined as 'Excluded Accounts' continue to have a low risk of being used to evade tax.

Wider approach

The wider approach document extends the CRS due diligence procedures to cover all non-residents or residents of jurisdictions for which a particular jurisdiction already has an exchange of information instrument in place (also known as the 'big bang' approach). The purpose of this document is to allow FIs to avoid performing additional due diligence each time a new jurisdiction becomes a signatory to the CAA.

Timetable

A group of countries, known as the 'early adopters', have committed to a start date for the CRS in 2016. Australia has not yet made any commitment to a particular start date.

Treasury discussion paper

The Australian government has not yet made any final decisions on implementation of the CRS in Australia. In June, the Australian Treasury released a discussion paper seeking industry input to assist the government with its decisions for CRS. The discussion paper asked questions on areas such as:

- FIs that should be covered
- The expected impact on FIs with multinational operations
- The accounts that should be reported
- The 'big bang' approach
- The use of current reporting mechanisms, such as the annual investment income report, for CRS reporting
- Alignment of CRS to AML/CTF customer due diligence requirements
- Timetable for implementation
- Expected costs of implementation.

In anticipation that Australia will implement the CRS, many FIs are beginning to consider the impact of CRS and its differences to FATCA. Many are also contributing to the consultation process.

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