



# Corporate Tax Alert

## Stay informed of new developments

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Greetings from your tax team at Deloitte Singapore. We are pleased to enclose for your information the latest Deloitte Tax Alert on:

## IRAS issues guidelines regarding income tax treatment of hybrid instruments

The Inland Revenue Authority of Singapore (IRAS) has recently issued an e-tax Guide on "Income Tax Treatment of Hybrid Instruments".

The Guide illustrates the approach adopted by the IRAS in determining whether a hybrid instrument is to be treated as equity or debt for Singapore income tax purposes. This distinction is important to issuers and investors alike as it determines the deductibility and taxability of payments and receipts arising from such instruments.

### Characterisation of hybrid instruments

Presently, there are no specific provisions in the Singapore Income Tax Act ("SITA") that stipulate the conditions or factors in determining the nature of a hybrid instrument, i.e. whether it is a debt or equity instrument.

Pursuant to the Guide and from the IRAS' perspective, the first step in determining the characterisation of a hybrid instrument such as redeemable preference share as either debt or equity is to determine its legal form; where the legal terms of the instrument indicate

ownership interests<sup>1</sup> in the issuer, the instrument is generally regarded as equity.

### **Singapore-based issuers of hybrid instruments**

Where the legal form of the hybrid instrument issued by a Singapore-based issuer is not indicative of the legal rights and obligations, the IRAS would examine the facts and circumstances surrounding the instrument and a combination, of the following (non-exhaustive) factors in order to determine the characterisation of the hybrid instrument: -

<b>Factors to consider</b>	<b>Equity</b>	<b>Debt</b>
Investor acquires shareholding and residual interest in the issuer	✓	
Investor acquires right to participate in issuer's business	✓	
Instrument confers investor with voting rights	✓	
Principal sum: there is a fixed repayment date in a reasonably foreseeable future and repayment is not conditional on business performance of the issuer		✓
Principal sum: where there is no fixed repayment date, there is incentive for the issuer to redeem the instrument (such as a step-up feature which provides for an increase in the distribution rate at a specific point in time)		✓
Distributions: cumulative and payment is not conditional on business performance		✓
Investor has unconditional right to enforce payment of distribution and repayment of principal amount		✓
Regulatory authorities (other than IRAS) in Singapore regard hybrid instrument as debt, e.g. the issuance of the instrument would affect the borrowing limit imposed on the issuer.		✓
Where right of investor to repayment of principal is subordinated to that of general creditors or to holder of subordinated debt of the issuer	✓	
Where investor is required to bear current or future losses of the issuer by way of either a write-down of the principal amount of such instrument or conversion to ordinary shares of the issuer	✓	

The classification of the instrument under the Singapore Financial Reporting Standards ("SFRS") is not conclusive, i.e. even if a hybrid instrument is classified as a financial liability under the SFRS, the characterization of such instrument for tax purposes would still be

<sup>1</sup> Such as the contribution of capital in exchange for capital gains/losses, periodic returns (e.g. dividends), voting rights or participation in the business.

based on the above 'legal form' and 'combination of factors' approach.

### ***Foreign-based issuers of hybrid instruments***

Similarly, in relation to the characterisation of hybrid instruments issued by a foreign-based issuer, the IRAS would examine the factors listed in the above table in totality (i.e. 'combination of factors' approach).

The IRAS has stated that it will also consider the characterisation of the instrument in the country of the 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, the IRAS appears to have taken a leaf out of OECD's recommendations to address mismatches in the tax treatment of hybrid instruments across jurisdictions<sup>2</sup> under its action plan to address Base Erosion and Profit Shifting (BEPS).

Nevertheless, the IRAS acknowledges that the characterization of a hybrid instrument should be based on the full facts and circumstances and a combination of relevant factors including those mentioned in the Guide. There is no simple or single factor that can be employed in all cases. At this juncture, the Guide deviates from the recommended primary response under BEPS Action Point 2. It remains to be seen if the IRAS will ultimately accept the BEPS recommendations relating to hybrid instruments once those recommendations are finalized.

### ***Issuance of hybrid instruments by non-corporates***

For the avoidance of doubt, the Guide states that payouts from hybrid instruments issued by REITS and treated as equity are regarded as REIT distributions and not interest.

Although not specifically stated in the Guide, we believe that the same treatment should apply to distributions made by Registered Business Trusts<sup>3</sup>.

<sup>2</sup> Recommended response under BEPS Action Point 2 to neutralise tax effect of hybrid instruments:-

- a) Jurisdictions should deny a deduction for any payment made under a hybrid financial instrument to the extent that the payee does not include the payment as ordinary income under the laws of any jurisdiction; alternatively
- b) Jurisdictions should require a payee to include any payment made under a hybrid financial instrument as ordinary income to the extent that the payer is entitled to claim a deduction for such payment (or equivalent tax relief) and the payer's jurisdiction does not apply a hybrid mismatch rule in accordance with the recommendation in (a).

<sup>3</sup> Where a hybrid instrument issued by a RBT is considered as equity, the distribution thereon should be exempt from tax under Section 13(1)(zg) of the SITA.

## Advance ruling

Advance ruling from the IRAS on the characterisation of the hybrid instrument is available for Singapore-based issuers. The issuer is required to communicate the ruling obtained from the IRAS to investors or prospective investors through appropriate channels such as the offering circular, information memorandum, website etc.

It is unclear whether the issuer is required to communicate adverse rulings by the IRAS, given that rulings are binding only upon the authorities. Also, although the Guide is silent, it should be possible for a Singapore-based investor to seek advance ruling on characterisation of an instrument issued by a foreign issuer for Singapore income tax purposes.

## Concluding thoughts

The SITA neither defines “interest” nor “dividends”.

Prior to the issuance of the Guide, it is observed that, in regard to instruments which are governed by Singapore law, the IRAS generally adopts a form-based approach, where the characterisation of an instrument for regulatory or corporate law purposes determines its tax characterisation.

Consequently, payouts from instruments that constitute share capital under Singapore corporate law<sup>4</sup> should be regarded as dividends by the IRAS. Such instruments include ordinary shares, preference shares as well as redeemable preference shares.

As a corollary, where Singapore corporate law recognises the holder of an instrument as a creditor of a company, such an instrument should prima facie be regarded as debt by the IRAS.

However, it was not previously clear how the IRAS would approach the characterisation of hybrid instruments that are governed under foreign law. Under Commonwealth case law, there is support for the so-called “similarity” approach, which calls for the identification of the rights and obligations which are carried by the instrument under the relevant foreign law, followed by a determination of which type of instrument under Singapore law the foreign instrument most closely resembles.

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<sup>4</sup> Companies Act (Cap 50.). Under this Act, payouts to holders of share capital are subject to capital maintenance rules which seek to protect the interest of creditors

The issue of the Guide on hybrid instruments is in line with the IRAS' recent stance to focus on the substance of an arrangement in determining the appropriate tax treatment. The nature of hybrid instruments, which straddle the grey middle ground of the debt-equity continuum, would in most instances entail an examination of the particular characteristics of the instrument before one can arrive at a debt or equity conclusion.

In this regard, the Guide issued by the IRAS is helpful as it spells out the factors considered by the IRAS in determining the characterisation of a hybrid instrument, especially in light of the proliferation of hybrid instruments such as perpetual bonds in recent years. Nevertheless, positions adopted in the Guide, whilst useful, are not the law and taxpayers may appeal to the courts to determine the correct position if they do not agree with the IRAS' position. For taxpayers that require certainty, the advance ruling option is useful.

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