

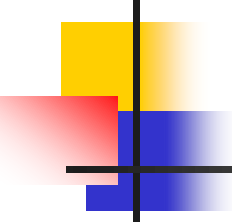
ICAI's INTERNATIONAL TAX COMMITTEE OF GOA BRANCH



Course on International Taxation Presentation on Hybrid Financial Instruments

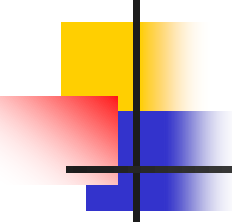
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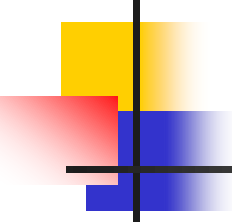
Overview of the Presentation

- Hybrid Instruments – A Meaning
- Application and Rationale
- Types of Hybrid Instruments
- Classification of Instruments by tax payer/s and statutory authority
- Taxation of payments and Treaty
- Double Taxation Relief
- A Case Study – UK and USA approach
- Hybrid Instruments and Thin Capitalisation
- Conclusion



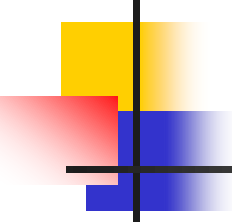
Hybrid Instrument : Meaning

- A Hybrid Instrument is a financial instrument that has economic characteristics that are inconsistent, in whole or in part, with the classification implied by its legal form.
- Hybrid financial instruments, Hybrid legal instrument or a Hybrid Accounting Instrument.
- Hybrid is not a tax term.
- A Domestic Hybrid Instrument.
- Terminology –
 - A document containing some legal right or obligation as may be referred.
 - Derivative
 - Issuer, Holder, Debtor, Creditor



Application and Rationale

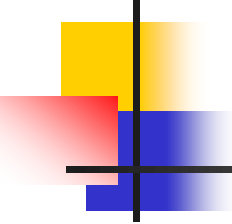
- Use of Hybrid Instruments
 - Tax, Accounting, Regulatory or Commercial motives.
 - Greater degree of flexibility to investor.
 - Tax Efficiency.
 - Capital taxes.
 - Tax Deferrel and Tax Arbitrage.



Types of Hybrid Instruments

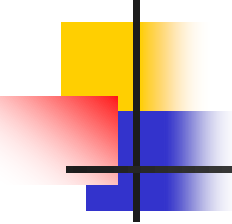
- Convertible Note or Bonds
- Dividend Yielding Bonds
- Perpetual Debts
- Profit Participating Loans
- Preferred Shares
- Redeemable Preferred Shares
- Sub ordinate debt
- Zero Coupon Bonds
- Loans

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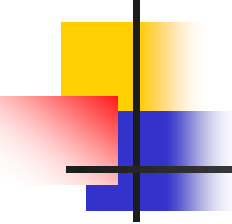
Types of Hybrid Instruments

- Bonds
- Debentures
- Discounted Securities
- Original Issue Discount Securities
- Jouissance Shares



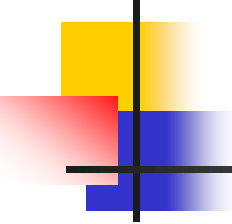
Classification of Hybrid Instruments – Tax Issues

- General Checklist
- Integration and Bifurcation approach
- Tax Issues for Issuer
- Tax Issues for Investor
- Issue arising out of a Cross Border transactions



Tax Implications under the DTAA

- Withholding tax varies with nature of payment – Dividend or Interest
- Nature of payment under Domestic Laws and DTAA
- Nature of the payment under Domestic Law of Source Country and Country of Residence
- “Dividend” under OECD model, Article 10
- “Interest” under OECD model, Article 11
- “Dividend” and “Interest” under Article “Tax Credit”

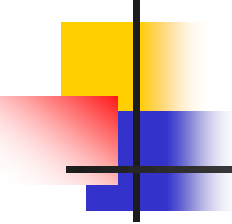


Definitions and Distinctions

- OECD model: Article 10(3)

The term “Dividends” as used in this article means income from shares, Jouissance shares or Jouissance rights, mining shares, founder’s shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.

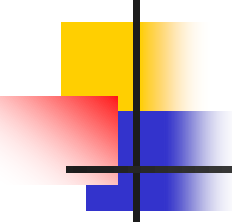
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Definitions and Distinctions

- OECD Commentary:- Paragraph 25 on Article 10
“Article 10 deals not only with dividends as such but also with interest on loans in so far as the lender effectively shares the risks run by the company i.e. when repayment depends largely on the success or otherwise of the enterprise’s business.

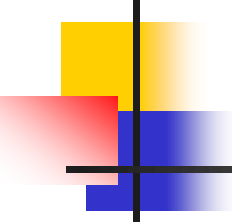
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Definitions and Distinctions

- OECD MC, Paragraph 19 on Article 11

Interest on participating bonds should not normally be considered as dividend, and neither as interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company.



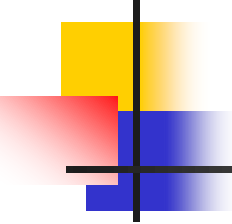
Article 11 of OECD model - Interest

- Article 11(3) of OECD model

Interest means,

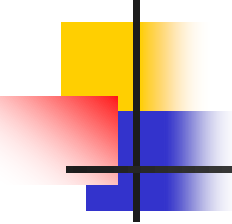
Income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profit, and in particular income from government securities and income from bonds or debentures, including premiums and prices attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article

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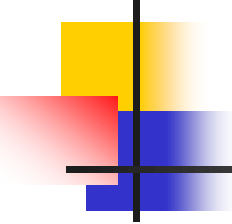
Article 11 of OECD model - Interest

- OECD MC, Paragraph 19 further states that
In order to avoid any possibility of overlap between the categories of Income dealt with in Article 10 and Article 11 respectively, it should be noted that the term Interest as used in Article 11 does not include items of Income which are dealt with under Article 10



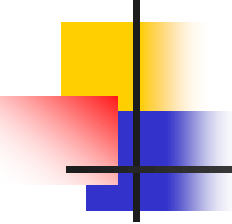
Double Taxation Relief – Tax Credits

- Classification in Resident state is similar to that of source state
- Classification in these state are different
- Varying Classification and Tax Credit methods
- Specific reference in the Relief Article for item of income by referring either Article or Income



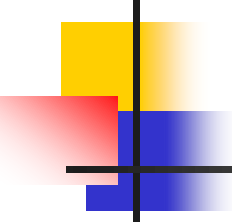
Double Taxation Relief

- Resident state may have its own rule of characterisation with broad relief rules or differing classification or leave the classification issue as a treaty matter
- Exemption method: Resident state will grant exemption and income will be classified under domestic law although not referred under the treaty.



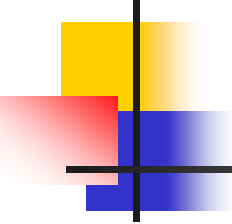
DTAA – Scope and issues

- Recharacterisation of Interest as dividend under domestic law – A case of Economic double taxation
- Excess interest as per Article 11(6)
- Applicability of Article 9
- Mutual Agreement Procedure – Its applicability
- Non discrimination – Article 24(4)



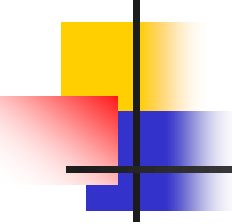
A Case Study – US Approach

- General Approach is to examine the objective facts.
- Objective Factors:
 - Factors relating to the degree of Investment risk
 - Right of the investor with respect to the issuer
 - Factors evidencing the subjective intent of the tax payer



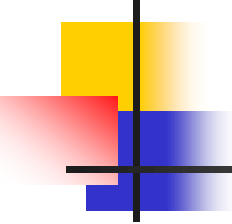
A Case Study – US Approach

- Characteristics of debt:
 - Is there any unconditional promise by the issuer to pay the certain sum on demand or certain date in future?
 - Does the holder possess the right to enforce payment of the principal sum and the interest due?
 - Are the note holders subordinate to creditors or do they participate in the management?
 - Is the issuer thinly capitalised
 - Is there a relationship between issuer and the holder
- If answer is 'Yes' to first two questions and 'No' to other questions. Answer is obvious.



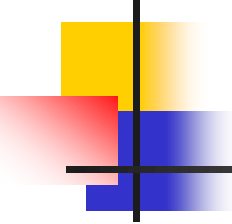
A Case Study – U.K. Approach

- Starting point in U.K. is to determine the nature of the instrument according to its legal form, rather than accounting treatment or the underlying economic characteristics of the instrument.
- Recharacterising something differently than its legal form requires considerable legislative effort.
- Thus, U.K. issuer issuing Hybrid Instrument to non U.K. investor, the domestic law of the investor does not impact the law for the issuer.



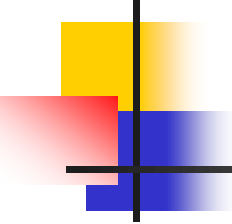
A Case Study – U.K. Approach

- U.K. investor, investing with non U.K. issuer:
 - Loan Relationship: Section 81 of the Finance Act 1996
 1. Subject to the following provisions of this section, a company has a loan relationship for the purposes of the corporation tax Acts, wherever:
 - a) The Company stands (whether by reference to the security or otherwise) In the position of a creditor or debtor as respects any money debt, and



A Case Study – U.K. Approach

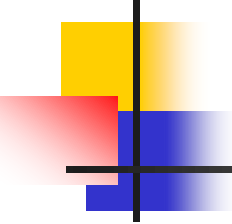
- b) that debt is one arising from a transaction for the lending of money; any reference to a loan relationship and to a company being party to the loan relationship shall be construed accordingly.
- 2. Section 81 (2): For the purposes of this chapter a money debt is a debt which falls to be settled:-
 - a) by the payment of money or
 - b) by the transfer of a right to settlement under a debt which is itself a “Money Debt”



A Case Study – U.K. Approach

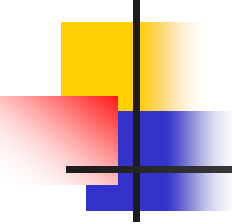
- Section 81(3): Subject to subsection (4) below, Where an instrument is issued by any person for the purpose of representing security for, or the rights of the creditor in respect of, any money debt, then that debt shall be taken for the purposes of this chapter to be a debt arising from a transaction for the lending of money.

Section 81(4): For the purposes of this chapter a debt shall not be taken to arise from a transaction for the lending of money to the extent that it is a debt arising from rights conferred by shares in a company.



A Case Study – U.K. Approach

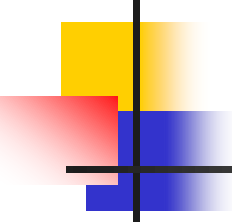
- U.K. investor is taxed on accruals or mark to market basis, irrespective of when the receipts fall due under the instrument itself, if relationship is that of a Loan [Section 85 of Finance Act 1996]



Integration Approach

A Case Study – U.K. Approach

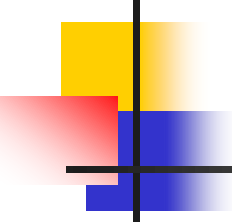
- Characteristics of payment to be distribution (u/s 209 of Finance Act 1996) by a paying company.
 - Interest payable depends upon the results of the issuing company.
 - Interest is payable on a bond which has unspecified maturity or a maturity in excess of 50 years and held by an associate company.
 - Underlying securities are convertible bonds and securities so converted will not be listed nor it carries the term similar to listed securities.
 - Security are connected with shares (disposal is possible together only)



Conclusion

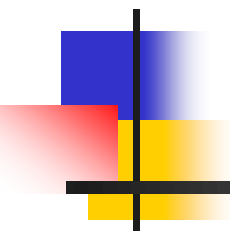
- Review

- Definition in issuer state and investor state of debt, equity and hybrid instrument
- Characterisation of the financial instruments used for creating hybrid instruments.
- Review Domestic Law of issuer and investor
- Review tax credit provisions
- Structure the financial transaction in a most tax efficient manner for issuer as well as investor
- Use of more than one financial instruments
- Use of Tax Jurisdiction/s



Income from Debt Claim – Income Tax Act, 1961

- Definition of Interest – Sec. 2(28A)
- Scope of Non Resident Taxation: Sec. 9(1)(i), Sec. 9(1)(v), Sec. 195, Sec. 10(4)
 - FCCB, FCEB
 - Zero Coupon Bonds, Deep Discount Bonds, [C. No. 2 of 2002 dt. 15.02.2002]
 - Characterisation under ITA 1961 of debt claims



Thank You
