IRAS e-Tax Guide

Income Tax Treatment of Hybrid Instruments

INLAND REVENUE
AUTHORITY
OF SINGAPORE

Published by
Inland Revenue Authority of Singapore

Published on 19 May 2014

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Income Tax Treatment of Hybrid Instruments

1 Aim

1.1 This e-Tax guide sets out the income tax treatment of hybrid instruments, including the factors generally used to determine whether they are debt or equity instruments for income tax purposes.

1.2 This guide will be relevant to you if you are an issuer, investor or potential investor of hybrid instruments.

2 At a glance

2.1 Hybrid instruments exhibit both debt-like and equity-like features. This table shows the tax treatment of hybrid instruments that are regarded as debt or equity instruments for income tax purposes:

	Regarded as debt	Regarded as equity
Issuer	Distribution is tax deductible if deductibility rules are met	Distribution is not tax deductible
Investor	Distribution is taxable unless specifically exempted from tax	Dividend is generally exempted from tax unless it is a foreign dividend that does not qualify for exemption[1]
		Distribution by REITs is generally taxable[2]

2.2 The first step in determining the characterisation of a hybrid instrument is to determine its legal form, which involves examination of the legal rights and obligations created by the instrument. A hybrid instrument is generally characterised as equity if the legal terms of the instrument indicate ownership interests in the issuer.

2.3 If the legal form of a hybrid instrument is not indicative of or does not reflect the legal rights and obligations, the facts and circumstances surrounding the instrument and a combination of factors would be examined. These factors include (but are not limited to):

(a) nature of interest acquired,

(b) investor's right to participate in issuer's business,

(c) voting rights conferred by the instrument,

(d) obligation to repay the principal amount,

[1] For details of tax exemption of foreign-sourced dividend, please refer to e-Tax guide "Tax Exemption for Foreign-Sourced Income".
[2] For details of tax treatment of REITs, please refer to e-Tax guide "Income Tax Treatment of Real Estate Investment Trusts".

(e) payout,

(f) investor's right to enforce payment,

(g) classification by other regulatory authority and

(h) ranking for repayment in the event of liquidation or dissolution.

2.4 The Singapore-based issuer of a hybrid instrument may seek an advance ruling[3] from the Comptroller of Income Tax ("CIT") on the tax treatment of the hybrid instrument. In this event, the ruling given by the CIT must be communicated to investors or prospective investors of the hybrid instrument.

[3] For details of the advance ruling and application procedures, please refer to e-Tax guide "Advance Ruling System".

3 Glossary

3.1 Foreign issuer

A foreign issuer is an issuer other than a Singapore-based issuer.

3.2 Hybrid instruments

These refer to financial instruments that exhibit both debt-like and equity-like features. Examples include convertible bonds, perpetual notes and profit participating loans.

3.3 Real Estate Investment Trust ("REIT")

A REIT[4] is a trust that is constituted as a collective investment scheme authorised under section 286 of the Securities and Futures Act (Cap. 289) and listed on the Singapore Exchange, and that invests or proposes to invest in immovable property and immovable property-related assets.

3.4 Singapore-based issuer

A Singapore-based issuer includes an issuer which is:

(a) an entity incorporated in Singapore;

(b) a trustee of a REIT; or

(c) a Singapore branch of a company incorporated outside Singapore, where the issuance of the hybrid instrument by the Singapore branch meets the requirements provided in paragraph 6.2.

[4] This is provided in section 43(10) of the Income Tax Act (ITA).

4 Background

4.1 Issuers of hybrid instruments are often concerned about the tax deductibility of distributions made on such instruments. Whether the distribution is tax deductible in the hands of the issuers is dependent on whether the hybrid instrument is a debt or equity instrument and whether other conditions for deduction are met.

(A) INCOME TAX TREATMENT

5 Characterisation of hybrid instruments

5.1 Presently, there are no specific provisions in the Income Tax Act ("ITA") which stipulate the considerations or factors for determining the nature of a hybrid instrument, i.e. whether it is a debt or an equity instrument.

5.2 In determining the characterisation of a hybrid instrument such as redeemable preference shares, the CIT takes the approach that the characterisation is first determined based on its legal form. This involves the examination of the legal rights and obligations created by the instrument. A hybrid instrument is generally characterised as equity if the legal terms of the instrument indicate ownership interests[5] in the issuer. If the legal form of a hybrid instrument is not indicative of or does not reflect the legal obligations and rights, then the characterisation of the hybrid instrument would be determined based on facts and circumstances and a combination of factors listed below.

5.3 The factors that the CIT considers when determining the characterisation of a hybrid instrument include but are not limited to the following:

(a) Nature of interest acquired

If the capital provided by an investor results in him acquiring shareholding and residual interest in the entity which issues the hybrid instrument, it suggests that the instrument is an equity instrument.

(b) Right to participate in issuer's business

A right for an investor to participate in the business operation of the issuer pursuant to the investor's investment in such instrument suggests that the instrument is an equity instrument.

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[5] Such as the contribution of capital in exchange for capital gains/ losses, periodic returns (e.g. dividends), voting rights or participation in the business.

(c) Voting rights conferred by the instrument

If a hybrid instrument provides an investor with voting rights at general meetings, it implies that the instrument is an equity instrument.

(d) Obligation to repay the principal amount

The presence of a fixed repayment date in a reasonably forseeable future in a hybrid instrument that requires the issuer of such instrument to unconditionally repay the principal amount on or by that date, regardless of the business performance of the issuer (i.e. whether it is deriving any profits), suggests debt characterisation of an instrument. In the absence of a fixed repayment date, the existence of a step-up feature[6] may imply that the issuer has an obligation to repay the principal amount. In contrast, if the repayment is conditioned on the financial well-being of the issuer of such instrument and there is no fixed repayment date or step-up feature in the hybrid instrument, it implies that the instrument is an equity instrument.

(e) Payout

Where –

(i) there exists a non-contingent obligation for an issuer to make a periodic distribution of a pre-determined amount to the investor, regardless of the business performance of the issuer (e.g. whether it is deriving any profits); and

(ii) the distribution is cumulative[7],

it supports debt characterisation of an instrument. On the other hand, where the payment of the distribution is at the discretion of the issuer, or when the distribution is non-cumulative or dependent on the issuer's profits, it suggests that the instrument is an equity instrument.

(f) Investor's right to enforce payment

If an investor has an unconditional right to enforce the payment of distribution and repayment of the principal amount, it supports debt characterisation of an instrument. Conversely, if the hybrid

[6] Refers to a feature which provides for an increase in the rate of distribution at a specific point in time or interval.

[7] A distribution is considered to be cumulative if the issuer is required to pay a distribution in the future when the distribution is not made at the point when it is due. Therefore when the distribution is cumulative, the obligation for the issuer to pay the distribution remains.

instrument does not provide the investor with any means to enforce the payment of distribution and repayment of the principal amount, it suggests that the instrument is an equity instrument.

(g) Classification by other regulatory authority

If any other regulatory authority in Singapore does not regard the hybrid instrument as debt for regulatory purpose, it implies that the instrument is an equity instrument. For example, a regulatory authority may determine that the issuance of the hybrid instrument would not affect any borrowings limit that may be imposed on the issuer if the regulatory authority regards the instrument as equity.

(h) Ranking for repayment in the event of liquidation or dissolution

If –

(i) the right of an investor to repayment of the principal amount is subordinated to that of general creditors or to holders of subordinated debt of the issuer; or

(ii) the investor is required to bear the 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,

this suggests that the instrument is an equity instrument.

5.4 The presence of any single factor may not suffice to classify the hybrid instrument as either debt or equity. To determine the characterisation of the hybrid instrument, a combination of factors and the facts and circumstances of the case have to be taken into account. Once the characterisation of a hybrid instrument is determined, the corresponding tax treatment would follow.

5.5 For accounting purposes, the characterisation of hybrid instruments is largely governed by the Singapore Financial Reporting Standards ("Standards"). The Standards predominantly look at the substance of the instrument to determine whether it should be classified as debt or equity in the issuer's financial accounts. Notwithstanding that a hybrid instrument is classified as a financial liability under the Standards, the characterisation of such instrument for tax purposes would still be based on the approach indicated in paragraphs 5.2 and 5.3.

5.6 Please refer to Appendices 1 and 2 for illustrations showing how a hybrid instrument is characterised as debt or equity for tax purposes.

6 Issuer of hybrid instruments

6.1 The CIT will apply the approach stated in paragraphs 5.2 and 5.3 to a Singapore-based issuer. Where a hybrid instrument is issued by a foreign issuer, the CIT will examine the facts and circumstances, including the characterisation of the hybrid instrument (i.e. whether debt or equity) in the country of the issuer, and the factors indicated in paragraph 5.3, for the purpose of determining the characterisation of the distribution derived by investors in Singapore.

6.2 Where the issuer is a Singapore branch of a company incorporated outside Singapore, the following requirements must be met before the issuer is regarded as a Singapore-based issuer:

(a) the instrument is issued solely and separately by (and not through) the branch;

(b) the instrument is reflected in the branch's accounts;

(c) the proceeds are used by the branch; and

(d) the instrument is not issued by the head office and transferred to the branch.

6.3 Accordingly, if the CIT characterises the hybrid instrument issued by the Singapore branch as an equity instrument and the country in which the head office is located also determines the character of the instrument as such, then the distribution from such instrument would be regarded as a dividend. Similarly, where the hybrid instrument is characterised as debt by both tax jurisdictions, the distribution from such instrument would be regarded as interest income that is deemed to be sourced in Singapore. In the event of a mismatch between how Singapore and the jurisdiction in which the head office is located characterises the hybrid instrument, the CIT will evaluate the basis for the different characterisations taking into consideration the specific facts of the case, before it determines the character of the instrument for Singapore income tax purpose.

7 Tax treatment of hybrid instruments characterised as debt

7.1 If a hybrid instrument is characterised as a debt instrument for tax purposes, the distribution from the issuer to the investor is regarded as interest.

7.2 The Singapore-based issuer of such instrument may be allowed a tax deduction on the interest expense incurred if the conditions governing deductibility of expenses under section 14(1) and if applicable, section 14(1)(a) of the ITA are met, and the deduction is not prohibited under any other provisions of the ITA.

7.3 The interest income from such instrument is taxable in the hands of the investor unless it is specifically exempted from tax under the ITA[8].

8 Tax treatment of hybrid instruments characterised as equity

8.1 If a hybrid instrument issued by a company or REIT is characterised as an equity instrument for tax purposes, distributions from the issuer to the investor are regarded as either dividends or REIT distributions.

8.2 No deduction will be allowed to the Singapore-based issuer of such instrument in respect of distributions paid to investors.

8.3 Where the dividend is paid by a resident company in Singapore, the dividend, being one-tier dividend, is exempted from tax in the hands of the investor. In all other cases, the dividend received by investors in Singapore will be subjected to tax. Nevertheless, the foreign-sourced dividend may qualify for tax exemption under either section 13(7A), 13(8) or 13(12) of the ITA.

8.4 In respect of REIT distributions, the tax treatment depends on the underlying receipts from which the distribution is made and the profile of the investors.

9 Timing of deductions and taxability of distributions

9.1 Where a hybrid instrument issued by a Singapore-based issuer is treated as a debt instrument, the interest expenses are generally considered as incurred by the issuer when its liability to pay the interest to the investor is crystallised. However, if the interest payment is deferred, the issuer's obligation to pay the interest would not be considered as crystallised on the scheduled interest payment date.

9.2 Similarly, the investor is liable to tax on the interest from such instrument when its legal entitlement to the income is crystallised.

9.3 If the issuer or the investor prepares its financial accounts in accordance with FRS39 and does not opt out of the FRS39 tax treatment, the provisions made under section 34A of the ITA would apply to the timing of the deduction and taxability of the interest.

(B) ADMINISTRATIVE PROCEDURES

10 Issuer of a hybrid instrument

10.1 A Singapore-based issuer who intends to issue a hybrid instrument may seek, before the issuance of the instrument, an advance ruling from the CIT on the characterisation of the hybrid instrument. In

[8] For example, interest derived by a qualifying non-resident or individual from qualifying debt securities is exempted from tax under section 13(1)(a) of the ITA.

addition, the issuer is required to communicate the ruling obtained from the CIT to investors or prospective investors through the appropriate channels such as offering circular, information memorandum and website.

11 Investor of a hybrid instrument

11.1 An investor of a hybrid instrument should refer to the offering circular, information memorandum, other document or information provided by the issuer to understand the tax treatment of the hybrid instrument. The investor should then apply the appropriate tax treatment on the income derived from such instrument.

11.2 An investor should seek clarification from the issuer if there are any doubts on the characterisation of the hybrid instrument.

12 Keeping of records

12.1 Both issuers and investors are required to maintain documents, for example offering circular, information memorandum or any other relevant documents relating to the hybrid instruments. These documents are to be provided to the CIT upon request.

13 Other information

13.1 This guide discusses the factors that the CIT will take into account in determining the nature of hybrid instruments and the corresponding Singapore income tax consequences. It does not deal with all forms of hybrid instruments currently available in the financial markets. As the financial market grows and becomes more sophisticated, new hybrid instruments with more complex features may be developed. Hence, 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.

13.2 The characterisation of a hybrid instrument should be made based on full facts, circumstances and a combination of relevant factors including those provided in this guide. There is no simple or single factor that can be employed in all cases.

13.3 This guide is issued based on the current tax laws of Singapore and the interpretation and practice of the CIT. Accordingly, the guide may not apply if there is any change in the tax laws and/ or change in the interpretation and practice of the CIT.

13.4 This guide does not preclude the CIT from disregarding or varying the arrangement and making such adjustments as he considers appropriate if the hybrid instrument is issued in connection with a tax avoidance arrangement to which section 33 of the ITA applies.

14 Contact information

14.1 If you have any enquiries or require clarification on this guide, please call:

(a) 1800-3568622 (Corporate)
(b) 1800-3568300 (Individual)

Appendix 1

CASE EXAMPLE OF A HYBRID INSTRUMENT TREATED AS DEBT FOR TAX PURPOSE

ABC is a Singapore-based issuer who issued subordinated perpetual securities ("Securities"). The Securities are issued at par. The Securities are constituted by a trust deed between the issuer and the trustee for holders of the Securities.

The main features of the Securities and the CIT's analysis to determine the character of the Securities for tax purpose are summarised in the table below.

	Factors	Features	Analysis
1	Nature of interest acquired	a. Does not fall within the definition of "share" under the Companies Act b. Holders of the Securities are not reflected in the Register of Shareholders but instead in Register of Debenture Holders. c. Not subject to capital maintenance rules under the Companies Act or the requirement that dividends be paid out of distributable profits. d. No approval is required for the issuance of the Securities	The features tend to support that the Securities are debt instruments.
2	Voting rights	No voting right.	A debt feature.
3	Obligation to repay the principal amount	No fixed repayment date but a step-up feature is present.	The step-up feature may result in higher cost for the issuer to keep the instrument, which may then lead to the issuer exercising its call option to redeem the instrument. Hence, this factor points the Securities towards a debt character.
4	Payout	The Securities bear a fixed periodic distribution. Although the issuer has sole discretion to	This feature supports a debt characterisation of the Securities.

	Factors	Features	Analysis
		defer the payment of distributions, any deferred distributions are cumulative.	
5	Ranking for repayment in the event of liquidation or dissolution	In the event of liquidation or dissolution, the Securities rank junior to the senior creditors of the issuer but *pari passu* with all other subordinated obligations of the issuer and ahead of the shareholders of the issuer	This feature supports a debt characterisation.
	Conclusion		**Treated as debt**

Appendix 2

CASE EXAMPLE OF A HYBRID INSTRUMENT TREATED AS EQUITY FOR TAX PURPOSE

DEF is a Singapore-based issuer who issued perpetual securities ("Securities"). The Securities are issued at 100% of the principal value.

The main features of the Securities and the CIT's analysis to determine the character of the Securities for tax purpose are summarised in the table below.

	Factors	**Features**	**Analysis**
1	Nature of interest acquired	As the Securities are legally subordinated debt instruments, no approval from common equity holders is required in respect of the issuance of the Securities.	This feature suggests that the Securities are debt instruments.
2	Voting rights	The Securities are legally subordinated debt instruments which carry no equity voting rights.	A debt feature
3	Obligation to repay the principal amount	The Securities have no maturity date and there is no step-up feature in the distribution rate. There is an obligation on the issuer to repay the holder, the principal value plus any accrued Distributions on the termination of DEF and upon the exercise of its optional redemption rights.	These features suggest that the Securities are equity instruments.
4	Payout	The Securities confer the holders a right to receive fixed-rate Distributions, semi-annually in arrears. The Distributions are discretionary and the issuer may elect not to pay a Distribution. Any missed Distribution is non-cumulative. However, the issuer has the discretion to make an optional payment equal to the amount of any missed Distributions.	As the payment of the Distribution is discretionary in nature and any missed payment is non-cumulative, these features point towards the instrument being equity in nature.
5	Right to enforce payment	The holders of the Securities have no rights to request or require redemption of the Securities and also no rights to request or require payment of the Distributions.	As the Securities do not provide the holders with any means to enforce the payment of distribution and

	Factors	Features	Analysis
			repayment of principal amount, these features suggest that the Securities are equity instruments.
6	Classification by other regulatory authority	The regulatory authority which regulates DEF does not regard the Securities as “borrowings”	This feature suggests that the Securities are equity instruments.
7	Ranking for repayment in the event of liquidation or dissolution	In the event of the winding up of DEF, the holders are regarded as if they are holders of a preferred class of equity in DEF, ranking ahead of holders of common equity of DEF but junior to the claims of all other present and future creditors of DEF.	This feature points the Securities towards being equity in nature.
	Conclusion		**Treated as equity**