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Taxation of Hybrid Instruments

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Abstract

The main purpose of the paper is analytical research of taxation of hybrid instruments in context of the EU parent-subsidiary directive. Efforts to harmonize taxation inside EU created negative side effects, which were unforeseen. The taxation of hybrid instruments became of the great importance as it created possibilities for development of schemes inside cross-border groups, which are somewhere in between of tax avoidance and tax evasion. This situation was recognized and the EU parent-subsidiary directive was amended in the year 2014. Member states are required to transpose amendments to national law by the end of the year 2015. Possible problems of implementation of amendments are presented on the example of Lithuania. Lithuanian local GAAP were too simplified in case of hybrid instruments and ways of adopting the Lithuanian legal system to the requirements of the amended EU directive are highly uncertain.

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Keywords: Taxation; Accounting; Hybrid instruments; Parent-subsidiary directive.

Introduction

The main purpose of the paper is research of taxation of hybrid instruments in context of the EU parent-subsidiary directive (PSD).

Research is based on analytical approach by application of hybrid instruments taxation model in cross-border groups. There are a few models already presented in scientific literature and there are many efforts to improve them or to apply them to more countries. The most comprehensive research in this field was done by Sven-Eric Barsch (Barsch, S-E, 2012).

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Efforts to harmonize taxation inside EU, to avoid double taxation and thus to create favorable conditions for business in some cases can create negative side effects which are unforeseen. The taxation of hybrid instruments has currently become of the great importance as a different treatment of hybrid instruments in accounting and taxation between countries inside EU creates possibilities for development of schemes inside cross-border groups, which are somewhere in between of tax avoidance and tax evasion.

The main problems rise from the implicit complexity of such instruments, having both equity and debt features. Only development of new detailed models for taxation of cross-border groups (Johannesen, N., 2014), which are based on numerous comparative studies (van Gelder, G., Niels B.,2013; Gajewski, D.,2012) and analysis of practice inside OECD and EU countries in fields of accounting and taxation, has proven that under certain scenarios such groups in one country could recognize dividends and deductible for tax purposes expenses at the same time as in another country. This situation was recognized on EU level and it was decided to change the PSD. The way in which the PSD was changed created many problems in its adaptation on national level.

Research results will contribute to further improvement of models of taxation of hybrid instruments in cross-border groups and could be used in process of amendments of Lithuanian laws, regulations and administrative provisions.

1. Background and main taxation mechanisms involved

Definition and classification of hybrid instruments varies by different sources, but for reason to avoid discussion on details of their definition existing consensus could be mentioned, that such instruments combine features of equity and debt. Combination of features is the most important point for research purpose. Both equity and debt are sources of financing business, but the first one is connected to ownership and the second is not. Such difference is results in different ways of treatment of related income or expense by income tax, so in the case of hybrid instrument we inevitably have issues in taxation as classification of instrument could implicit different tax regime. Actually all legislations separate taxation of dividends and interest. Further on, taxation of dividends and interest is associated with a certain set of tax mechanisms, particularly double taxation avoiding, participation exemptions, withholding tax, taxable income, deductible expenses, thin capitalization rule. All these mechanisms were developed historically, are of different nature and purpose. Part of them are oriented to protect the country of resident from profit transfer to other countries or tax evasion, another part is oriented to provide tax benefits for local businesses or foreign investors. There are still tremendous differences in tax rates, taxation rules and taxation practices in cross-border context. There were efforts to harmonize taxation for OECD countries on EU level, but the process is very slow and experts are not too optimistic to consider its outcome as quick and positive.

In case of hybrid financial instruments another important issue is accounting standards. Many countries have their own, so called local GAAP, which more or less are in line and do not differ too much from IAS/IFRS for the most simple everyday transactions, but could have important differences in case of more complicated issues, including accounting of hybrid instruments. Local accounting principles are important for taxation of hybrid instruments, as reporting usually is connected to financial reporting, for example in case of income recognition.

Complicated nature of hybrid instruments, differences in financial reporting and taxation among countries currently are the main causes for tax avoidance and evasion.

2. Taxation problems associated with hybrid financial instruments

In the most cases, taxation of dividends and interest is well regulated. The main problem with taxation of dividends is of economic nature. It is widely recognized that double taxation, for example as taxation of source in country resident and as income in country receiving dividends cannot be accepted from an economic point of view, as the same profit will be taxed twice. Therefore some additional mechanisms were developed and namely the participation exemption mechanism. The participation exemption is a mechanism where under certain criteria usually a level of control and period of investment held, taxation of dividends is eliminated. The participation exemption mechanism is one of the most important mechanisms ensuring free capital movement in cross-border structures. For example, PSD is using the participation exemption mechanism to ensure capital flows in the form of free cross-border flows of dividends inside EU.