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**Article**

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Contemporary Economics

**Provided in Cooperation with:**

VIZJA University, Warsaw

*Suggested Citation:* Gajewski, Daniel (2012) : The Role of Hybrid Instruments in the Implementation of Business Tax Policy, Contemporary Economics, ISSN 2084-0845, Vizja Press & IT, Warsaw, Vol. 6, Iss. 2, pp. 84-90,  
<https://doi.org/10.5709/ce.1897-9254.43>

This Version is available at:

<https://hdl.handle.net/10419/105358>

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Received: 21 12 2011 | Accepted: 28 05 2012

# The Role of Hybrid Instruments in the Implementation of Business Tax Policy

Dominik Gajewski<sup>1</sup>

## ABSTRACT

The purpose of this article is the presentation of issues related to hybrid instruments. We will primarily focus on the analysis of various aspects of hybrid instruments and entities. The use of these instruments produces fairly significant tax implications that have specific effects on the holdings of capital group companies operating worldwide, and these companies therefore frequently use hybrid instruments to optimise their tax policies. This study identifies numerous issues that may be critical to these firms when designing an optimal tax policy, without losing sight of the fact that fiscal policy is an essential determinant of the financial standing of a company. In particular, this article discusses the tax consequences of various policies given the different tax systems used in the European Union countries, focusing upon the specific conditions and implications of the Polish tax system.

**KEY WORDS:** income tax, hybrid instruments, hybrid entities.

**JEL Classification:** H21, H25

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## Introduction

In the current era of increasing globalisation, the exchange of information, knowledge and technology is very common, as is a highly efficient allocation of production resources that reduces capital and transportation costs. The need to efficiently manage a business that is subjected to numerous distinct tax regimes has contributed to the development of international tax planning initiatives.

The analysis of the transactional flows of entities in a firm's holdings, as well as the adaptation of the tax strategy and other tools of tax planning to the regulations that are in force in various tax regimes, offers ample opportunities for a firm to maximise the efficiency of its financing and acquire long-term tax savings. By contrast, a company that does not use tax planning tools may forfeit the possibility of obtaining tax benefits (Niels, 2010, p. 255).

Hybrid tools are among the most significant tax planning instruments. To accurately detail the functioning of hybrid instruments, it is important to distinguish between the two principal forms of company financing, namely, debt and asset financing.

The optimisation of the tax policy of holding companies has become an expected economic reality, as holding companies create their economic position by implementing an effective tax policy. It is the optimisation of tax strategy that enables groups of entities to provide significant capital cost savings compared with a single firm, particularly in an international environment. As Lazonick and O'Sullivan (2000, p. 18) rightly note, European holding companies, to a growing extent, finance themselves either from external sources in the capital markets or through loans from banks. Given the prevalence of this holding company strategy, it is essential for these firms to have a rational policy that optimises their taxation.

In this context, the thesis that hybrid instruments are the key tools in shaping a holding firm's tax policy appears to be merited.

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### The concept of hybrid instruments.

Groups of companies (holding companies) are becoming increasingly common in a globalised economic reality. Nonetheless, according to Froud, Haslam, Jokal and Williams (2000, p. 1261), mainstream economics still devotes insufficient attention to the largest corporations, given their economic importance in the modern world.

Holding companies are typically comprised of companies that are located in different countries; as a result, these subsidiary companies are subject to different tax regimes. This situation creates significant implications for the international tax policy planning of these holding firms. The effective management of a holding firm can produce tax benefits by establishing various forms of capital flows among the firm's holding entities, planning proper fiscal policy for the firm and implementing tax planning tools that are appropriate for the various tax regulations applicable to its subsidiaries. In contrast, if a holding company does not use tax planning tools, it may lose the possibility of obtaining tax benefits (Finnerty et al., 2007, pp. 71-72). It is important to remember that hybrid tools (broadly defined and including both hybrid instruments and entities) are among the available instruments for tax planning.

The concept of hybrid instruments does not include any previously unknown financial instruments but rather incorporates widely known debt instruments, typically loans and bonds. The idea underlying a hybrid instrument is the exploitation of a duality in the tax classification of various regimes. In particular, these instruments are designed such that in one regime, they are treated as regular loans for which interest is an expense that is deductible from taxable income, whereas in another regime, based on local internal tax law, these instruments are considered to be the capital contribution for a company, and the interest received from these instruments is treated by a lender (or a bondholder, in the case of bonds) as a dividend, which in certain countries is exempted from taxation or taxed more favourably than income from interest (Fiszer, 2009, p. 21).

Within a financial structure, hybrid instruments can broadly be treated as derivatives. Derivatives are securities that are derived from assets, events or other characteristics of reference (called the primary or un-

derlying instruments), with varying values dependent upon the performance of those underlying instruments (McBride, 2000/1999, pp. 31-32).

The following types of derivatives exist (Kolb, 1997, p. 68):

1. options (call and put);
2. contracts (futures and forward);
3. swap contracts (interest rate and currency);
4. hybrid instruments.

By definition, a hybrid entity is associated with an existing entity category, such as a partnership or company, that may also have dual characteristics for tax purposes in two different legislations. The essence of the hybrid entity is the duality of the income tax qualifications that the entity has received (Ostrowska, 2007, pp. 31-32). For example, in one legislation, a business will be formally run and taxed as a separate legal entity, whereas under the internal tax law of another country, it will be fiscally recognised as a partnership for which income will pass through to individual partners for taxation purposes; thus, a tax levied in one jurisdiction may be proportionally applied towards the future tax liabilities of each partner in another jurisdiction. A classic example of a hybrid entity under Polish tax law is a limited liability company. In Poland, this type of firm is a legal entity which is subject to The Legal Persons Income Tax Act. By contrast, according to U.S. tax law, American taxpayers may opt to treat the income received by a limited liability company in which they hold shares as income or loss from a partnership. Thus, one entity, for tax purposes, can be treated differently in two different countries, providing additional opportunities for legal tax planning designed to minimise the overall tax burden on the taxpayer (Fiszer, 2009, p. 21).

### The taxation aspects of hybrid instruments and entities

To understand the essential aspects of hybrid instrument functionality for holding firms, it is necessary to distinguish between the two forms of company financing, namely, debt and equity financing.

The tax laws of most EU countries clearly distinguish between equity and debt funding methods. Debt financing consists of the use of foreign assets for an agreed-upon remuneration. When a company pays remuneration for the use of foreign assets (e.g., real estate owned by others or cash loans), it receives tax benefits applicable

to its business (Wilson, 1999). In fact, the vast majority of existing tax regulations assume that such remunerations directly affect the size of the paying firm's income tax base, and therefore, tax laws often specify that these payments are tax-deductible expenses (Finnerty et al., 2007, p. 72). It is worth noting that tax laws also provide for restrictions on the recognition of interest expense as a tax-deductible expense. This restriction is particularly reflected in the regulations related to thin capitalisation (Brzeziński & Hayder, 1997, p. 34; Wells, 1993, p. 9; Fuest & Hemmelgarn, 2005, p. 521.), the regulations regarding transfer pricing (Dłuska & Kubińska, 1998, pp. 36-37) and the regulations addressing tax-deductible expenses made in favour of businesses that are managed in countries classified as offshore jurisdictions (Głuchowski, 1996, p. 36).

The main applicable principle for the majority of tax regimes is that the remuneration paid by a taxpaying company to its shareholders (dividends) does not result in a decrease in the size of the firm's income tax base.

Income that is obtained by an entity as compensation for providing funds to another, either in the form of capital or using a debt instrument (or derivative), is taxed under the tax law of the country where the beneficiary of the interest or dividend income conducts its business. If a company is based in an European Union country, its income from dividends may be untaxed due to participatory exemptions from taxation (Pfeiffer, Schiller & Wagner, 2011). Participation exemptions are subject to domestic tax laws that implement UE Directive 90/435/WE.

Most EU countries treat debt and equity differently for the purposes of determining a withholding tax basis. Certain countries (e.g., the United Kingdom), in accordance with their internal law, do not provide for a withholding tax upon dividends paid to shareholders that are considered to be foreign residents for tax purposes, whereas withholding taxes are mandatory on all interest income. However, it is important to recall the fundamental principle that, when considering the payment of remuneration on debt financing (interest) and capital received (dividends), the recipients of these payments must consider the potential tax consequences of a withholding tax in the source state. The existing agreements addressing the avoidance of double taxation favour corporate tax minimisation of these consequences. Moreover, companies that are based in the

European Union are able to avoid or minimise their exposure to the withholding tax thanks to national regulations that implemented community law (EU Directive 90/435/WE for dividends and EU Directive 2003/49/EC for interest and royalties). Alternatively, agreements between the countries where the company paying interest or dividends and the entity receiving those payments are located can allow for the avoidance of double taxation by either excluding certain firms from withholding taxation or providing for the implementation of a preferential withholding tax rate for firms that satisfy the conditions of these agreements.

In conclusion, financing via debt or equity instruments is associated with the analysis of the following specific taxation aspects:

- tax obligations related to the payment of the withholding tax when a company remunerates a financing source for providing funding;
- tax consequences for the entity paying this remuneration to compensate its funding sources;
- tax consequences for the recipient of the remuneration payment(s) in question.

Given the above analysis of aspects of taxation, it is noteworthy that from the viewpoint of the entity which has paid the remuneration for its financing, the optimal solution would involve the use of a debt instrument that creates the possibility of tax base reduction (because interest is classified as a tax-deductible expense). By contrast, from the viewpoint of the entity which receives the remuneration, the most attractive tax treatment would be achieved through capital financing instruments, as the dividends received from these instruments would be subject to participation exemptions. According to Poterba (2004: 554), it is obvious that the best solution would be to use an instrument that would both permit the entity making remuneration payments to deduct these payments for tax purposes and avoid creating taxable income for the recipient of these payments. A hybrid instrument is a tool that can produce these desired tax effects.

The definition of a hybrid instrument states that it is a financial instrument with an economic character that is wholly or partly inconsistent with the classifications imposed by its legal form (Duncan, 2000, p. 129). A hybrid instrument is distinguished by the presence of features that either produce contradictory

tax classifications or prevent the application of any tax classification at all.

Internally inconsistent features of the hybrid instrument result in it being subjected to different tax treatments in the various legislations or tax regimes in which it is used. For company financing purposes, the use of a hybrid instrument with characteristics that do not clearly indicate whether it is a debt or capital instrument may lead to scenarios in which one country considers the instrument in question to be a debt, whereas another nation treats the same financing method as a capital instrument. In this type of situation, for companies operating in the EU, the payment of remuneration from the issue of hybrid instruments can become a tax-deductible interest expense, whereas remuneration received from the same instrument may be treated as dividends received from capital funding, which are subject to the participation exemption for the beneficiary of the dividend in question (Finnerty, Merks, Petriccione & Russo, 2007).

Moreover, when an additional consequence of using a particular hybrid financing instrument is that it produces no withholding tax, the instrument in question can be employed to optimise the tax burden of the companies that belong to one capital group (holding).

Thus, the following main tax benefits result from the application of an appropriate hybrid instrument:

1. the recipient of remuneration from the hybrid financing instrument in question is exempt from dividend taxation if that recipient is located in the same European Union country as the entity that pays the remuneration;
2. the entity that pays this remuneration may be able to treat that payment as a tax-deductible expense if that entity is located in a different country of the European Union from the recipient;
3. hybrid instrument remuneration paid to a beneficiary is not subject to a withholding tax.

The following characteristic features of certain financing tools allow these tools to be treated as debt instruments:

- the funds must be repaid within the agreed period;
- the amount of remuneration for the use of the provided funds is strictly defined;
- an inability to control the firm that obtains the funds from the instrument (the capital beneficiary);
- a legal claim for repayment of the provided funds.

The following characteristic features of certain financing tools allow these tools to be treated as capital instruments:

- the provided funds must be repaid as a part of the basic capital reduction or liquidation of the capital beneficiary;
- the return on provided funds is dependent upon the financial results of the capital beneficiary;
- the entities providing funds have the ability to control the recipient company (the capital beneficiary);
- the inability of entities providing funds to strictly enforce the return of the provided capital (if considering repayment priority, these entities have inferior status relative to creditors of the capital beneficiary).

Both hybrid instruments and hybrid entities may be aspects of the hybrid structures companies use to meet their financing needs.

By definition, a hybrid entity is one that is considered to be a tax resident by the applicable tax legislation of one country, whereas another country considers the entity in question to be transparent from a tax perspective, i.e., not subject to tax liability in that country (Larking, 2005). Thus, a hybrid entity may be described as creating a classification discrepancy between two countries regarding their recognition of this hybrid entity as a taxable business. This discrepancy is directly related to the specific legal form of a hybrid entity, which, in certain countries, allows the entity to bypass legal recognition as a transaction entity from the tax perspective. There may also be cases in which a hybrid entity creates a different classification conflict because one country treats the entity as a company, whereas another country regards the same entity as an establishment of a foreign company. This situation is caused by the fact that countries recognising the entity as a tax resident do not account for the jurisdiction in which the entity in question was established (Lamers & Stevens, 2004).

### **The influence of hybrid instruments on the tax policies of Polish entrepreneurs**

There are many examples of the functioning of both hybrid instruments and hybrid entities. A typical example of a hybrid instrument is a loan granted for a period of 80 years that allows capital providers to

participate in the capital beneficiary's profits. This tool has characteristics of typical debt instruments because it must be returned within strictly specified time restrictions. This tool can also demonstrate features of capital instruments, such as remuneration that is dependent on the financial results of the capital beneficiary and the inferiority of capital providers relative to other creditors of the capital beneficiary. This example of a hybrid instrument belongs to a category known as perpetual loans. Perpetual loans consist of loans that either lack a definite maturity date or specify that maturity will not occur for a prolonged time (typically longer than 50 years). An important observation is that perpetual loans are regarded as capital in certain countries (for example, the Netherlands and Luxembourg), whereas in other countries, these instruments are treated as loans (for example, the United Kingdom, France, Spain, Portugal and Italy). A hybrid instrument with diverse and opposing features may be used for structuring transactions that are optimal from a tax perspective. For the purpose of taxation optimisation, other hybrid instruments are also used, e.g., loans converted into capital, preferential shares and loans that explicitly account for profit shares. These hybrid instruments are all characterised by traits of both equity and debt.

In addition to hybrid instruments, hybrid entities can be used in the creation of a firm's taxation policy as well. These hybrid tools allow the companies included in the parent firm's holdings to achieve optimal transaction structures from a tax perspective. Each hybrid entity in either the European Union or the U.S. is characterised by being subject to tax in the country where it was established while remaining transparent for tax purposes in other countries (Lamers & Stevens, 2004).

It is worth noting which issues are of significance when addressing the importance that hybrid instruments will have under Polish tax law. In particular, we must consider the issue of whether, in the context of tax planning structures, it is possible to involve Polish taxpayers in the use of hybrid instruments for tax planning.

The Polish law clearly and precisely defines the economic categories that are considered to be capital. The majority of hybrid instruments, including perpetual loans, loans with profit participation and loans converted into equity, belong to the category of debt instru-

ments. Therefore, Polish taxpayers may treat the interest paid as part of the use of these hybrid instruments as a tax-deductible expense. Of course, this tax treatment is subject to the statutory restrictions imposed by general legislation addressing the income tax of individuals and defining deductible costs, as well as specific regulations about thin capitalisation, regulations regarding transfer pricing and restrictions applying to the tax treatment of transactions involving tax havens.

Therefore, it is possible to use Polish entities in international tax planning involving hybrid instruments, provided that the funding obtained through these instruments would be classified as an equity investment for the financing provider.

An example of the possible involvement of a Polish entity is a situation in which a Dutch holding company would grant a perpetual loan to a Polish company. For the Dutch company, the payment received in exchange for this financing would be treated as a dividend and would be subject to a participation exemption. By contrast, for the Polish company, the interest paid on this perpetual loan could be treated as a tax-deductible expense. Currently, the structures described in this example (within the duration of the transitional period prior to the full implementation of the relevant EU directive's regulations) result in an obligation to assess a withholding tax for the interest payment to Holland; however, an agreement between the two nations in question to avoid double taxation reduces the rate of this withholding tax to 5% in Holland. Moreover, it should be recalled that at the end of the transitional period (July 2013), the discussed example will no longer result in the obligation to assess this withholding tax.

## Summary

It is worth recapitulating the issues discussed above to answer the question of whether the classification distinctions between different countries regarding the scope of the taxation of various financial instruments imply that hybrid instruments and entities should be treated as elements for creating the fiscal policy of holding companies or whether these hybrid tools should be thought of as methods for circumventing tax laws.

Individual countries are attempting to introduce restrictions addressing the use of hybrid instruments and entities in the shaping of a firm's tax policy. Certain



legislative proposals may introduce clauses and restrictions that limit the possibility of using instruments that are characterised by inconsistent treatment in different regimes. It should be noted, however, that European legislation cannot predict all possible means of tax planning that are in accordance with the regulations of domestic law yet exploit methods of optimising the tax treatment of a company's holdings as a whole.

Existing legal conditions may, according to Devereux, Lockwood & Redoano (2008, p.1221), result in harmonisation of the tax policy on income tax, which would be particularly desirable during the current global economic crisis. As Clausing (2007, p. 128) mentions, we should not forget that the rate of corporate income tax will not decrease in the future in all EU countries, as the EU governments will have to repay their recently incurred debts.

The EU countries employ different tools to counteract the dissimilar classifications of financial instruments. These include the following measures:

- clauses prohibiting certain circumventions of the pre-existing tax law;
- rules that synchronise the instrument tax classification in several countries, for example, the regulation applied inter alia in Italy and the Netherlands that allows for exemption from taxation of the remuneration income derived from a financial instrument only when the payer of that income cannot classify the expenditure in question as a tax-deductible expense (New, 2002; Jackson, 1990).

The analysis of the aforementioned examples of regulations restricting the use of financial instruments that use classification differences for tax purposes clearly demonstrates that the possibility of hybrid instrument use will be limited in certain countries. According to current domestic regulations, a hybrid instrument can be regarded as a tool to circumvent the tax law and minimise a tax burden, but under the synchronising regulations, it will not be possible to derive the positive tax effects (exemption from taxation) for situations in which the remuneration for the financing instrument used will constitute a tax-deductible expense for the capital beneficiary.

It should be recalled, however, that a significant number of EU countries (including Poland, for example) do not include the limitations discussed above

in their tax regulations. The lack of these limitations permits the tax planning and implementation of the optimal tax financing structures for holding companies to be conducted in accordance with the domestic law of these nations.

Hybrid tools play an enormous role in the tax policy of holding firms, and should be recognised as very helpful instruments for optimising the tax policy of these companies despite the many controversies created by the authorities of the EU countries regarding the tax implications of these hybrid tools. The functions of holding firms are specifically designed to enable the use of hybrid instruments, a conclusion that particularly applies to international holding companies, which are managed under the auspices of numerous different tax regimes.

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