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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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).
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.
Taxation of interest also has a sound economic background. It is recognized that needs of business development create demand in financing sources, so interest is considered as regular business expense and therefore should be tax deductible.

Mentioned general principals of taxation of dividends, interest in fact became classic theoretical cornerstones of economics, finance and taxation. In practice many distortions in applications of these principals became obvious, as there are still big differences in tax rates and tax regulations among countries worldwide. Reaction to such distortions was development of additional protective taxation mechanisms as withholding tax and thin capitalization rule. The main goal of withholding tax and the thin capitalization rule is to protect the country resident from transfer of profit through interest to other jurisdictions by reducing taxation of profit in the resident country.

Combination of general principles of taxation with protective tax mechanism created very complicated multilayer taxation structures, when the particular resident country for some other legislations recognizes participation exemption and for others does not, or for some countries applies withholding tax and for others does not. The overall picture becomes even more complicated because of application cross-border double taxation avoiding treaties.

Development of hybrid instruments made cross-border taxation system even more complicated (Harris, P., 2014). It is agreed that hybrid instruments have features both of equity and debt. This simple fact theoretically creates some additional distortion to the taxation system as proceeds from the same instrument could be dividends on interest (Wood, R., 1999). Current practice of hybrid instruments developed such complicated structures, that sometimes the board of experts expires difficulties in their recognition and proper classification. If we put hybrid instruments in a multilayer taxation system briefly described above, there is possibility that proceeds from the same hybrid instruments in one country will be recognized as dividends and as interest in another one. As approaches for taxation of dividends or interest are different, conflict in recognition may result in additional benefits for cross-border structure using such instruments.

The most controversial scenario in case of hybrid instrument in cross-border structure will arise when in one country it will be recognized as pure debt and in another as pure equity. If there is no withholding tax between countries and the participation exemption mechanism exists, in the resident country proceeds from hybrid instrument could be treated as interest and therefore are fully tax deductible and in another country proceeds could be treated as dividends and are non-taxable income. Under such scenario, cross border structure will receive additional benefits as income the tax required to be paid in the resident country will be lower.

The paradox of such a controversial scenario is requirement of rather developed taxation system with free cross-border flows of capital, what are mostly features of well developed economies (HM Treasury, HM Revenue&Customs, 2014). The main preconditions are a working participation exemption mechanism and an absence of withholding tax. These preconditions can usually be created by bilateral or multilateral international treaties. Another important precondition is existence of differences in recognition of hybrid instruments by local GAAP which is still quite often a feature of well developed economies. In case of less developed economies possibility of such a scenario is very low because of application of withholding tax and even double taxation of profit. It could be concluded that problems with taxation of hybrid instruments could be seen as a negative side effect of efforts to ensure free cross-border movement of capital.

3. Situation on EU level

Achievement of free capital flows inside the EU is long-run goal and is one of the most important conditions for existence of a single EU market. Harmonization of taxation inside the EU is very important for free capital flows and could also be treated as very important condition for single market development. It took many years of discussions between member states to negotiate and to implement PSD afterwards (2011/96/EU, adopted in November 2011). In process of harmonization of taxation PSD is considered as one of the most successful and powerful vehicles. The basic logic and taxation mechanisms involved in PSD were presented above and include elimination of double taxation, removal of withholding tax and participation exemption for EU cross-border groups.

On the other hand, within the period of a few years after adaptation PSD was highly criticized because of negative side effects. There are still big differences in taxation inside EU countries and competition for capital inflows between EU member states is existing. In general these differences were in line with PSD, otherwise will be resulted
in development of legal case on EU level for particular country, but these existing differences are material enough to create some distortions for single market.

One of the main negative side effects of PSD is considered to be development of artificial holding structures where country resident for parent company is based not on business logic but on some taxation benefits existing between countries inside EU.

Another problem is existing local GAAP in member states with significant differences also. Regardless of recognition of IAS/IFRS on EU level, such situation creates potential niche for different recognition of hybrid instruments, which represent traditionally one of the most complicated areas of accounting.

Previous analysis of preconditions for taxation problems related to hybrid instruments in combination with the current situation inside the EU clearly indicated the existence of perfect seeding-ground for applying schemes to achieve some additional tax benefits. Simple application of a classic fraud triangle to hybrid instruments, indicated that as always there was constant pressure for optimization/minimization of taxes in cross-border groups even inside the EU, there were opportunities because of a well developed taxation system on one side and the taxation and accounting differences between member states on the other side and rationalization because the most such schemes were almost legal.

Following a previous approximately two year discussion two amendments to PSD were done in the year 2014 (Council of the European Union, 2014A, 2014B). Member states will have until 31 December 2015 to transpose the new amendments of the PSD by introducing an anti-abuse rule and the amendments to tackle hybrid loan mismatches into national law.

General principle, which is applied in the amended PSD (Council of the European Union, 2014A), is described as follows: “refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary, and tax such profits to the extent that such profits are deductible by the subsidiary”. This principle is shortly presented, but its implementation will be quite complicated as it will be necessary to change national tax systems and in some cases even accounting standards.

4. Implementation of PSD amendments in case of Lithuania

In general, the Lithuanian tax system should be considered as developed and as in EU member state all requirements of PSD were transposed to Lithuanian national law. Taxation mechanisms as avoiding of double taxation, participation exemption, withholding tax and others are in place, are widely applied and commented by Lithuanian tax authority. There were some problems and discussions with the European Commission considering compliance with application of withholding tax in cross-border structures previously, but it is was not leading to a legal case against Lithuania, as national laws were changed with some transition period given for implementation. Cross-border structures with companies outside EU regularly do not have such favorable taxation regimes, for exempt of cases of bilateral double taxation avoiding agreements between Lithuania and other countries. All mentioned features confirmed that in Lithuania there is taxation system previously described as multilayer.

This positive situation is not the case for the taxation of hybrid instruments, as national laws and regulations are rather weak. Historically Lithuania applies as local GAAP national Business accounting standards (BAS) which in fact are simplified subset of IAS/IFRS. Simplification is achieved by excluding some accounting alternatives and simplified treatment of more complex financial instruments including hybrid instruments. For example, treatment of hybrid instruments is limited to convertible bonds and all convertible bonds should be recognized as liability until the moment of conversion if any occurs and preference shares should be recognized as equity (18 BAS).

Such simplification is grounded by practical consideration and by fact, that the biggest and listed Lithuanian companies have applied a set of IAS/IFRS recognized in the EU, and opposite BAS are applied usually by SMEs.

In case of taxation of hybrid instruments and necessity to implement the last amendments of PSD this simplification will lead to a more complicated process. As was previously mentioned some links between accounting standards and taxation rules always exist. In case of Lithuania simplification of accounting of hybrid instruments consequently resulted in simplification of taxation rules and there are no separate regulations, for example all proceeds from a Lithuanian company belonging to cross-border structure for preference shares will be treated by tax systems as profit and all proceeds from convertible loans will be treated as interest.
Because of simplification in Lithuania hybrid instruments in fact are accounted and taxable as not hybrid instruments but as separate debt or equity instruments, so the main problem is the creation of a special tracking system of hybrid instruments and their proceeds. There are two basic cases for analysis – when the parent company is located in EU except Lithuania and when parent company is located in Lithuania. In case when the parent is located in EU such a tracking system should provide information on accounting and taxation of particular financial instrument to the foreign tax authority. In case of the parent is located in Lithuania the national tax authority will need to get relevant information from the foreign tax authority. It is not clear how the formal mentioned tracking system should be and if it will be operational on a permanent or on a case-by-case basis.

**Conclusions**

Efforts to create a favorable business environment by establishing free cross-border capital movement could create unforeseen negative side effects. The most interesting recent case is implementation of the EU parent-subsidiary directive. Harmonization of taxation on an EU level and at the same time existence of big differences in taxation and accounting on level of separate member state created severe taxation problems in treating of complex financial instruments as hybrid instruments are treated. Within a short period after adaptation, it became necessary to amend parent-subsidiary directive in the year 2014. In the case of Lithuania, simplification of accounting for hybrid instruments under local GAAP also resulted in simplification of taxation of such instruments. Therefore, classification of hybrid as pure debt or equity will require development of special tracking system of application of hybrid instruments by cross-border groups. It is impossible to implement amendment of the parent-subsidiary directive without establishing intensive information exchange on hybrid instruments between national tax authorities inside the EU.

**References**


