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# FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY AND POTENTIAL TAX IMPLICATIONS OF THEIR BOOKKEEPING

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## ABSTRACT

The study analyzed the potential tax effects of hybrid financial instruments in equity. Due to the lack of sufficient accounting rules, debt/equity instruments were analyzed as this hybrid category was identified as a tool for aggressive tax planning. Using a rational approach, the study verified that hybrid instruments can be used in cross-border investments to gain tax benefits due to interest expenses from subsidiaries in one country, whereas investors in another jurisdiction, could recognize these values as dividends and consequently obtain tax advantages. These instruments can be applied to reduce the Thin-capitalization Index (TCI) and avoid tax risks. The study concluded that, hybrid financial instruments could be studied by international groups e.g., Base Erosion and Profit Shifting (BEPS) from the tax point of view to inhibit these instruments from being issued with intent to reduce effective tax rates by means of tools developed on the basis of rules of asymmetry.

**Keywords:** Hybrid Financial Instruments. Tax. Foreign Investments. Thin-capitalization.

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# INSTRUMENTOS FINANCEIROS COM CARACTERÍSTICAS DE PATRIMÔNIO E POTENCIAIS IMPLICAÇÕES TRIBUTÁRIAS DE SUA CONTABILIZAÇÃO

## RESUMO

O objetivo central deste artigo é avaliar potenciais implicações tributárias do registro contábil de instrumentos financeiros com características de patrimônio. Foram analisados, mais especificamente, os híbridos de capital e dívida em razão da ausência de tratamentos contábeis específicos para esses títulos, bem como das alegações de que essa categoria vem sendo utilizada como um potencial instrumento para arrojados planejamentos tributários. Por meio de uma abordagem lógico-dedutiva, verificou-se que os híbridos de capital e dívida podem ser empregados em contextos em que há investimentos internacionais, com a intenção de que investidas em uma jurisdição se valham da dedutibilidade fiscal dos juros, enquanto investidoras localizadas em outro domicílio fiscal possam reconhecer os mesmos proventos como dividendos recebidos e, por conseguinte, não os tributar ou tributá-los a taxas reduzidas. Nesse cenário, os híbridos funcionariam à espécie de conversores financeiros com a finalidade de reduzir a carga tributária do grupo. Do mesmo modo, verificou-se que os referidos instrumentos financeiros podem ser aplicados como forma de reduzir os índices de subcapitalização, potencialmente afastando o risco de glosa fiscal por descumprimento das regras dessa natureza. Em linhas gerais, conclui-se que, sob o enfoque fiscal, os instrumentos híbridos devem ser estudados por meio de grupos interjurisdicionais (e.g. BEPS), visando impedir sua emissão com o propósito de redução da carga tributária por meio de artifícios criados sobre assimetrias de ordenamentos jurídicos.

**Palavras-chave:** Instrumentos Financeiros com Características de Patrimônio Líquido. Instrumentos Financeiros Híbridos. Tributação. Investimentos Estrangeiros. Subcapitalização.

## 1 INTRODUCTION

The impact of taxation on profit has been subject of discussion in the field of corporate finance for many years. One example is the adjustment made by Modigliani and Miller in 1963 to their seminal work published in 1958, wherein they reconsidered their previous assumptions because of a new understanding of how the capital structure of organizations can affect profit-related taxes and consequently, the value of corporations.

A wide range of studies have addressed the topic of capital structure, and, among its main considerations, the tax argument gains expressive contours because it directly affects the expected returns of the investors (Lee & Tu, 2011; Cigola & Pecatti, 2005; Gupta & Newberry, 1997; Myers, 1984; Myers & Majluf, 1984; Miller, 1977; Ross, 1976).

Kahraman, Beskese and Ruan (2004) stress that investors rely on discounted cash flow models to make their decisions. More specifically, the authors emphasize

that dividends come from profits after taxation, which is why the issue of taxes from a capital structure perspective is relevant. To complement this, Bade (2009, p. 1476) clarifies that “one of the most important equations in modern finance theory and practice is the WACC textbook formula accounting for the capital structure and resulting tax consequences on valuing a stream of cash flows.”

In this association between capital structure and taxation on profit, it is possible to mention without prejudice to other readings, that the interest paid on loans and financing, when taken as deductible for tax purposes, reduces taxable profits and thus achieves the concept of tax savings. Nonetheless, with regard to composition, there is a balance that is expected between the financial liabilities and owners' equity of the organizations. As debt instruments offer benefits that reduce the effective tax burden, they also increase financial leverage and expose companies to a situation of less liquidity and greater vulnerability.

It is important to note that although equity instruments improve financial indicators by reducing leverage and increasing cash and cash equivalents, they generally have higher capital-raising costs. This is because the allocators of economic resources will be tied to the position of the investors (e.g., Oztekin & Warr, 2014; Lee & Gentry, 1995; Bonaimé, Myers, & Majluf, 1984), thus subjecting them to the risks of the operations of the organizations in which they participate as holders of residual rights over the net assets of the company in which they have invested.

This dichotomous context—wherein debt instruments reduce tax burden but worsen financial indicators and, in contrast, equity securities improve these indicators but result in higher capital-raising costs—has given rise to hybrid financial instruments. According to Hopkins (1996, p. 33), they are “financial instruments which include characteristics of both debt and equity”.

Hopkins (1996) asserts that hybrid instruments are financial products that combine the characteristics of pure, simple debt, which may involve certain particularities, such as degrees of subordination in the event of extrajudicial liquidation, with other characteristics of capital, which may (or may not) involve equity interest in the results of the issuer, up to certain limits. They are hybrid, as expressed in the word itself, in that they emanate from the crossing of different species or strains.<sup>5</sup>

While the understanding behind these contracts submits to an almost intuitive reasoning over the aforementioned hybridism, formalization of the accounting process<sup>6</sup> for such securities is extremely complex, especially in a system based on principles, such as the International Financial Reporting Standards (IFRS). This is demonstrated by a project in the International Accounting Standards Board (IASB), which aims to issue clearer rules for the accounting treatment of financial instruments with characteristics of equity, a term that would encompass the entire

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<sup>5</sup> For more details: In this study, we do not comply with the IFRS definition of hybrid securities, as the reader will understand further on.

<sup>6</sup> We refer to the accounting process as the reporting, measurement, and disclosure stages of an economic event in financial statements.

spectrum of financial products that blend characteristics between financial liabilities and equity instruments (IASB, 2019).

In this context, this study sets out to investigate the potential tax effects resulting from the accounting of hybrid instruments. Therefore, we applied deductive logic, which, according to Martins and Theóphilo (2009), can be considered a process whose basis lies in the chosen assumptions consistent with dialectical logic.

It is imperative to emphasize that this study does not intend to exhaust or end the discussion that has already been set out. The main focus of this study was to assess how reporting of this type of contract can affect taxation on profits from two different perspectives: (i) obtaining tax cuts given a context of investments among different jurisdictions and (ii) affecting thin capitalization rules.

No assessments for any location were made regarding specific tax rules. The central proposition of this study was to establish guidelines on using this type of instrument for tax planning purposes, without specifically noting its practice in specific jurisdictions.

The perspectives adopted to develop this study resulted from comments expressed by the Organization for Economic Cooperation and Development (OECD, 2012):

There are financial instruments that include characteristics of both debt and equity (or seen from the creditor/shareholder: loan and shares). These financial instruments are usually known as hybrid financial instruments and include instruments such as preferred shares and profit participating loans.

Member states will not necessarily qualify these hybrid instruments in the same way. If there is a mismatch in the qualifications of such financial instruments between member states (i.e. as debt in one jurisdiction and as equity in the other), double non-taxation might occur. (OECD, 2012, p. 6)

In summary, asymmetric treatment among countries with respect to the taxation of revenues or expenses arising from hybrid financial instruments could potentially generate imbalances in the allocation of economic resources by investors. More notably, the benefits arising from gaps in the tax regulation of these contracts cause the real rates of return on investments to change. Consequently, capital allocators are expected to find incentives for arbitration to direct their cash flows to jurisdictions that permit the use of hybrid securities as a tax planning tool.

The rest of this study was organized as follows. Section (2) examines the concept of hybrid financial instruments in light of the different interpretations of this terminology. Section (3) addresses the disparities in the use of such contracts for tax cuts through international investments. Section (4) contextualizes how hybrid instruments would affect thin capitalization rules. Our final thoughts in Section (5) sum up the main points and conceptions discussed.

## 2 WHAT ARE HYBRID FINANCIAL INSTRUMENTS AFTER ALL?

Without the intention to exhaust other interpretations, it is possible to mention that the term “hybrid instruments” has been used deliberately by the academic

community connected to accounting and finance, financial institutions, and investors to designate securities linked to capital-raising that combine both the characteristics of debt securities and equity instruments. Some examples of financial instruments that could be listed as hybrid are financial products such as perpetual bonds, convertible bonds, redeemable preference shares, among others.

It is noteworthy, however, that a list of all the financial instruments eligible for the hybrid concept cannot be drawn up based on the aforementioned perspective, especially since there are "infinite" possibilities for the preparation of these products, which in this sense outdates any inventory quickly, and consequently the initiative becomes counterproductive.

Accordingly, it is essential to understand the components of this category of financial instruments, such that a hybrid instrument is reported through its taxonomy. For this purpose, it is opportune to conduct a review from the most basic to the most advanced concepts on the subject.

According to paragraph 11 of IAS 39<sup>7</sup>, "a financial instrument is any contract that gives rise to a financial asset for the entity and a financial liability or equity instrument for another entity," as translated by way of CPC 38 in Brazil. This approach explains the contractual nature of this category of elements as well as the expectation that financial assets for one entity correspond to financial liabilities or equity instruments for another entity.

The definition provided by IAS 39 offers a potentially adequate understanding for a variety of transactions involving financial instruments. Nevertheless, its deterministic, tight characterization of the positions between the parties involved in a contract of this nature seems to have led to the emergence of a new concept, a term coined hybrid financial instruments.

The term hybrid also appears in IAS 39, as shown by the following excerpt describing the term: "10. An embedded derivative is a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative".

As suggested by IAS 39 with regard to the term "hybrid instrument," it indicates that there is a principal, non-derivative contract, in addition to a derivative. We note that this definition is not in any way similar to the aforementioned positions by Hopkins (1996). From an accounting perspective, the definitions presented by both are closer to the concept of compound instruments, as provided by IAS 32, translated as CPC 39<sup>8</sup> in Brazil, more specifically in the following subparagraph: "28. The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component".

In summary, hybrid instruments taken from a non-accounting perspective are contracts that combine characteristics of both capital-raising sources, whether in the form of financial liabilities or equity instruments (e.g., Johannessen,

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<sup>7</sup> These definitions have not changed with the publication of IFRS 9 - Financial Instruments, which came into effect in 2018. Free translation.

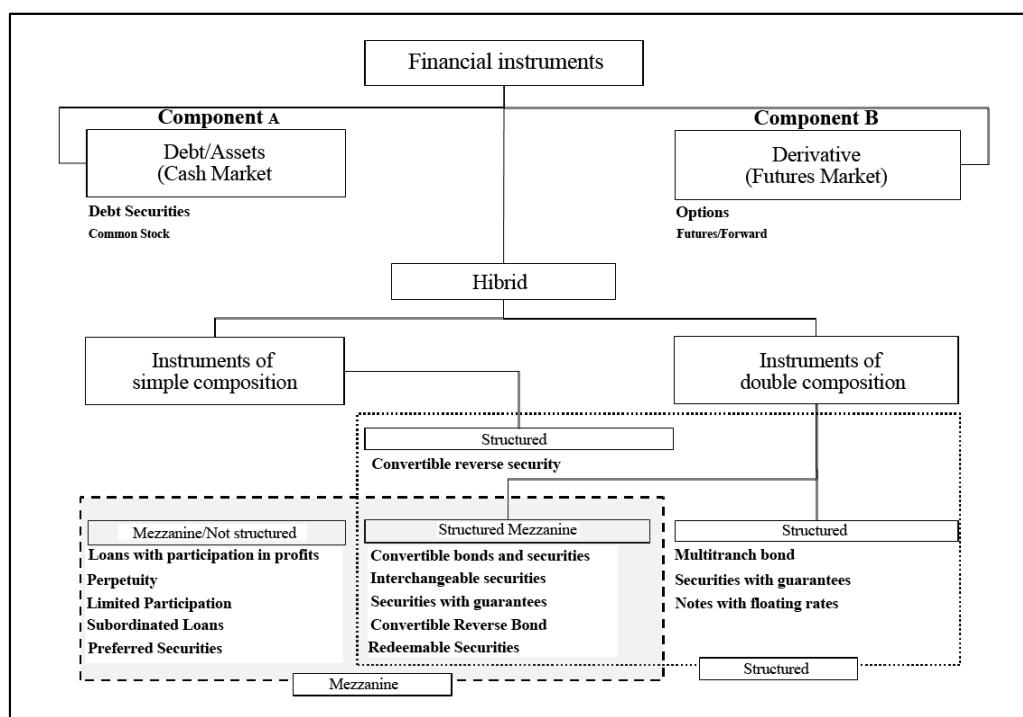
<sup>8</sup> Free translation.

2014; Barsh, 2012; Dutordoir & Gucht, 2007; Ammann, Kind & Wilde, 2003; Lee & Figlewicz, 1999; Roon & Veld, 1998; Hopkins, 1996). In terms of the accounting standards, hybrid instruments are formed by the combination of derivative and non-derivative instruments in the same contract (IAS 39). Compound instruments arise from transactions that result from the joint presence of at least one equity instrument accompanied by a financial liability (IAS 32).

This terminological imprecision can be attributed to a relevant portion of the problems related to the subject, evidently, the academic community, standard setters, and market professionals have tried to define the term as if the expression portrayed a single type of contract. However, the taxonomy of transactions reveals that the concept is closer to a genre or a nexus of distinct possibilities, as shown in Figure 1.

Component A represents the outlook for debt and equity securities traded in spot markets, while component B denotes a set of first-generation derivatives which, when combined with items from component A, result in contracts with embedded derivatives.

Structured transactions are the result of a mixture of primary instruments, which allow us to understand the economic nature of their debt, equity, or both (in the case of compound securities, as provided in IAS 32). The designated mezzanines indicate the financial instruments in Brazil that have been referred to as "capital and debt hybrid instruments." It can be established that the term mezzanine illustrates the idea that something exists between the two sets. Hybrid instruments of this nature would be placed between liabilities and owners' equity given the consideration of their characteristics.



**Figure 1** – Taxonomy of hybrid financial instruments

Source: Adapted from Barsch (2012).

The IASB (2019) initiated the project "Financial Instruments with Characteristics of Equity," possibly aware of this terminological diversity and its implications in the accounting treatment of this list of financial instruments, which proposes a new nomenclature for these securities, with the purpose to clarify which aspects to observe for the accounting records of these papers.

In this context, financial liability or owners' equity are classified based on the details of the securities, which are, minimally, its (a) form of payment, (b) term to maturity, (c) subordination to other debt and equity instruments, and (d) repurchase rights (e.g., IASB, 2019; Hopkins, 1996).

Within these aspects, it can be established that hybrid financial instruments are not confined to a single category of products or contracts, as expressed in the new nomenclature provided by the IASB (2019); it would therefore be a mistake to seek guidelines for an exhaustive definition for this terminology. Barsch (2012) corroborates this finding by indicating that these instruments do not contemplate borderline definitions. Johannessen (2014, p. 40)<sup>9</sup> underscores that this complexity in definition arises from the possibility of hybrid instruments combining characteristics of debt and equity in different ways.

Thus, it is possible to establish that hybrid financial instruments can be understood as contracts related to capital-raising, which combine elements that are typical of debt and equity instruments, leaving accountants with the task of carrying out a substantiated analysis of the economic essence of such products to clearly determine their accounting records.

### **3 THE POTENTIAL TAX EFFECT OF HYBRID FINANCIAL INSTRUMENTS WITHIN THE CONTEXT OF INTERNATIONAL INVESTMENTS**

Capital structure has notable impact on the taxation of profit (e.g., Lee & Figlewicz, 1999; Lee & Gentry, 1995; Modigliani & Miller, 1963). More specifically, the deductibility of interest expenses is one of the points to consider when determining the capital structure of a given entity.

As for hybrid financial instruments, Lee and Figlewicz (1999) highlight that one of the key characteristics of these securities is the attainment of fixed yields based on profit or principal. Accordingly, these considerations can be interpreted as interest, which may result in the deductibility of such amounts from the tax base for taxable income.

Carvalho and Flores (2014) portray this scenario in the explanatory note by Telekom Austria, in which the company mentions using the deductibility from payments made as compensation for hybrid financial instruments.

Upon analysis of the explanatory note, it can be observed that Telekom Austria issued hybrid financial instruments and reported them as financial liabilities for the purposes of the local financial statements to obtain deductibility from the paid interest. However, the same securities were presented as equity instruments

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<sup>9</sup> "hybrid financial instruments can combine characteristics of debt and equity in any number of ways."

in the consolidated statements (in IFRS), possibly in an attempt to reduce their financial leverage. In other words, a “double standard” (Telekom Austria, 2013, p. 81).<sup>10</sup>

### Hybrid capital

On January 24, 2013, Telekom Austria Group issued a hybrid bond with a volume of TEUR 600,000. The hybrid bond is a subordinated bond with indefinite maturity which is, based on its conditions, classified as stockholders' equity according to IFRS. Accordingly, related discount and issue cost in the amount of TEUR 11,752 were recorded net of a tax benefit of TEUR 2,938 in stockholders' equity. Therefore, stockholders' equity was increased by TEUR 591,186. The bond can be redeemed at the earliest after a period of five years. Additionally, Telekom Austria AG has an early termination right subject to certain conditions. The annual coupon amounts to 5.625% until the first reset date, February 1, 2018. Subsequently there will be a reset date every five years. The coupon is established two days prior to the respective reset dates. Coupon payments will be recognised as dividend payments in stockholders' equity.

In the local financial statements, coupon payments are recognised as an interest expense in profit or loss according to Austrian GAAP. While the tax benefit resulting from the accrued interest is recognised in profit or loss according to local GAAP, it is recognised in stockholders' equity as “distribution of dividend” in the consolidated financial statements according to IAS 12. The net result attributable to hybrid capital holders is presented in the consolidated statements of profit or loss and equals accrued interest according to local GAAP amounting to TEUR 30,971, net of the relating tax benefit of TEUR 7,698, which is recognised in stockholders' equity.

Johannesen (2014, p. 40) stresses that, “The rules demarcating debt and equity for tax purposes differ between countries, hence the possibility that a hybrid financial instrument is treated as equity in one country and debt in another.” From this perspective, another strategy for obtaining tax benefits through the use of hybrid instruments would be through foreign investments. For Desai et al. (2006),

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<sup>10</sup> Free translation: **Capital Híbrido**

Em 24 de janeiro de 2013, o Telekom Áustria Group emitiu um título híbrido com um volume de TEUR 600.000. O título híbrido é um título subordinado com prazo indeterminado que, com base em suas condições, é classificado como patrimônio líquido de acordo com o IFRS. Consequentemente, o desconto relacionado e o custo de emissão no valor de TEUR 11.752 foram registrados líquidos de um benefício fiscal de TEUR 2.938 no patrimônio líquido. Portanto, o patrimônio líquido foi aumentado em TEUR 591.186. O título pode ser resgatado após um período de cinco anos. Além disso, a Telekom Áustria AG tem um direito de rescisão antecipada, sujeito a determinadas condições. O cupom anual é de 5,625% até a primeira data de redefinição, em 1 de fevereiro de 2018. Posteriormente, haverá uma data de redefinição a cada cinco anos. O cupom é estabelecido dois dias antes das respectivas datas de redefinição. Os pagamentos de cupons serão reconhecidos como pagamentos de dividendos no patrimônio líquido.

Nas demonstrações financeiras locais, os pagamentos de cupons são reconhecidos como despesa de juros no resultado, de acordo com o GAAP austriaco. Embora o benefício fiscal resultante dos juros acumulados seja reconhecido no resultado de acordo com o GAAP local, é reconhecido no patrimônio líquido como "distribuição de dividendos" nas demonstrações financeiras consolidadas de acordo com a IAS 12. O resultado líquido atribuível ao capital híbrido detentores é apresentado nas demonstrações consolidadas do resultado e é igual a juros acumulados de acordo com o GAAP local no valor de TEUR 30.971, líquido do benefício fiscal relativo de TEUR 7.698, que é reconhecido no patrimônio líquido.

the use of financial entities in countries or premises with favorable taxation<sup>11</sup> is a widespread practice among the organizations.

Johannsen (2014) investigated the conditions in which the use of hybrid financial instruments may generate tax benefits through foreign investments. With this objective, the author indicates that the boundaries between debt and equity securities are not deterministic, and given the composition of tax regulations in general, there is relative uncertainty regarding the tax treatment for hybrid instruments. Therefore, due to the applicable tax treatment, the author concludes that the issuance of hybrid securities resides in a probabilistic context.

Drawing from Johannsen (2014) and expanding on the examples, we may consider the issuance of a hybrid instrument whose considerations are reported as financial expenses and, respectively, taken as a reduction from taxable profit. Thus, there are two mutually exclusive ways in which tax authorities may interpret this treatment:

- (i) as validation of the tax procedure executed by the issuer of the instrument, with a probability of  $P(i)$ , or
- (ii) as a disregard for amounts reported as interest expenses, thereby considering them non-deductible for tax purposes, with a probability of  $P(ii) = 1 - P(i)$ .

Hybrid instrument issuers are expected to deduct the amounts paid as yields from these securities, when  $P(i) > P(ii)$ . Additionally, it is possible to presume that  $P(i)$  will reach closer to 1 if there is a structure that makes use of companies based in other countries, thus making tracking difficult for local tax authorities, and allowing for the amounts raised to be internalized in the final jurisdiction as legitimate debt securities.

Let us consider that organization **A** based in country **X** has contributed 100 million euros to offshore company **a** in tax haven **K**. In turn, **a**, by way of a hybrid financial instrument totaling 90 million euros, has allocated resources in **b**, another offshore company of the same financial conglomerate located in tax haven **Y**. Finally, **b** acquires a debt security in the amount of 85 million euros from company **D** based in country **W**. Table 1 presents a summary of this transaction by way of a general accounting chart, given that the entire transaction was conducted in the same functional currency.

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<sup>11</sup> According to IN SRFB 1037/10 in Brazil, countries or premises with favorable taxation are considered to be in locations that either do not tax income or tax it at a rate under 20% (twenty percent), or even locations whose internal legislation does not allow access to information relative to the corporate composition of legal entities or their ownership. The jurisdictions considered to be countries or premises with favorable taxation are listed in this normative provision.

**Table 1**

Accounting effects of the issuance of hybrid financial instruments through offshore companies

	<b>A Country (X)</b>	<b>a Country (K)</b>	<b>B Country (Y)</b>	<b>Δ Country (W)</b>
<b>Asset</b>				
- Cash and Equivalents	(a) € 400.000.000	a) € 10.000.000	b) € 5.000.000	c) € 85.000.000
- Investments	(a) € 100.000.000			
- Investment / HFI		b) € 90.000.000		
- Investments / Securities			€ € 85.000.000	
<b>Liability</b>				
- Debt security				€ € 85.000.000
<b>Owners' Equity</b>				
- Capital	€ 500.000.000	a) € 100.000.000		
- Capital-raising / HFI			b) € 90.000.000	

(a) – Capital contribution of € 100 million of  $\lambda$  in a.

(b) – Acquisition of Hybrid Financial Instruments (HFI) issued by  $\beta$  in the amount of € 90 million.

€ – Acquisition of debt securities by  $\beta$  in the amount of € 85 million, issued by  $\Delta$ .

Source: Authors (2020).

To attain tax advantages from the example above, let us consider that hybrid financial instruments are treated as owners' equity in country **K** and as debt in country **Y**. Thus, in one country there will be treated as interest expenses which shall be received as dividends that were received in the other country.

In summary, the tax advantages of the example shown in Table 1 might be understood more easily by observing only company **A** and its subsidiary **Δ**. Taking into account the payment flows of the structured transaction, it is possible to verify that company **Δ** will report financial expenses arising from the debt securities issued along with its result, and it will most likely consider these amounts as deductible for the purpose of taxing profits in country **W**. Company **A**, on the other hand, will receive dividends as a form of payment for its investments, which cannot be subjected to a new tax levy in jurisdiction **X**.

From a probabilistic point of view, it is possible to mention that the inclusion of offshore entities created a scenario in which the probability of success determined by the lack of questioning by tax authorities can be defined as  $P'(i)$ , where  $P'(i) > P(i)$ , given the premise that in this new context hybrid instruments would be hidden through the use of intermediaries **a** and **β**.

Hypothetically, the costs for building companies were not considered, mainly because of the reasoning that such a transaction would only be executed if the gains resulting from the reduction of the effective tax burden with the transaction exceeded the respective expenses.

Moreover, the transaction assumes that company **A**, based in country **X**, operates under "safe harbor" conditions with respect to the non-taxation of dividends received from company **Δ**. Nevertheless, the exemplified transaction could be understood, if detected, by the tax authorities as a tax evasion

mechanism, since the use of offshore companies would have occurred only to detach them from a direct capital contribution from  $\Delta$  to  $\Delta$ .

Johansen (2014) highlights that if the hybrid instrument is first treated as equity in the country of the first vehicle entity and as debt in the jurisdiction where the second conduit is located and the cash flow of the instruments is identical, then there will be no tax impact on the countries wherein the vehicle companies are based.

To effectively demonstrate the tax benefits arising from this structuring, let us presume from one year to the next,  $\Delta$  paid the amount of 1 million euros as remunerative interest to  $\beta$ , which in turn, considering the structured chain of the transaction, also paid interest in the amount of 1 million euros to  $\alpha$  as a form of compensation for the hybrid instrument issued. Given that hybrid instruments are treated as equity instruments in jurisdiction  $K$ , the amounts received from these contracts will immediately be treated as dividends received and not as interest revenue. Continuously,  $\alpha$  distributes dividends to  $\lambda$  in the same amount of 1 million euros, as demonstrated in Table 2.<sup>12</sup>

**Table 2**

Payment flow considering accounting disparities in the treatment of hybrid instruments

	$\Delta$ Country (X)	A Country (K)	B Country (Y)	$\Delta$ Country (W)
<b>Result</b>				
Revenue with Dividends (f)	€ 1,000,000	€ 1,000,000		
Interest Revenue			(d) € 1,000,000	
(-) Interest Expense			€ 1,000,000	(d) € 1,000,000
(=) Results	€ 1,000,000	€ 1,000,000	€ -	-€ 1,000,000
(-) Distributed Dividends		(f) € 1,000,000		

(d) -Interest payment of 1,000,000 euros from  $\Delta$  to  $\beta$ .

€ – Interest payment of 1,000,000 euros from  $\beta$  to  $\alpha$ , which shall be treated as dividends received in  $\alpha$ .

(f) – Distribution of dividends of 1,000,000 euros from  $\alpha$  to  $\lambda$ .

Source: Authors (2020).

The tax benefits of the abovementioned structure are more objectively demonstrated to the extent that there are no tax payments in the example shown. On the contrary, by focusing closely on Company  $\Delta$ , we observe that there was a generation of losses which will potentially reduce future taxable profits if country  $W$  accepts tax offsets for past tax losses.

In Country  $Y$ , no tax on profit is paid, as the amount of interest received equals the amount of interest paid.

Furthermore, the opportunity to use hybrid instruments to reduce the tax burden arises precisely from the accounting differences in understanding the nature of hybrid instruments between countries  $Y$  and  $K$ . When treated as a financial liability in jurisdiction  $Y$ , its payment is reported under the concept of financial expense, eliminating interest revenue in this jurisdiction. However, when it

<sup>12</sup> The constitution of reserves of any nature has been ignored for practical purposes, which implies considering that all earnings are distributed in the form of dividends.

is classified as an equity instrument in country **K**, its returns are established as dividends received, which are not offered for taxation, given the “safe harbor” regime.

Accordingly, the returns would reach original investor **A** in the form of revenue with dividends, having produced a deductible interest expense in the jurisdiction of subsidiary **D**.

Demonstrating in a counterfactual manner how the situation illustrated in Table 2 would not be possible if there was a conceptual alignment for the accounting treatment of hybrid instruments between countries **Y** and **K**, two versions of the same example are illustrated in Table 3. Panel A considers that both jurisdictions classify hybrid instruments as a financial liability; Panel B assumes that both countries qualify hybrid instruments as owners' equity.

**Table 3**

Counterfactual examples of the treatment of hybrid instruments considering a conceptual alignment between K and Y

**Panel A**

Both jurisdictions classify hybrid financial instruments as a financial liability

	<b>λ</b> Country (X)	<b>α</b> Country (K)	<b>β</b> Country (Y)	<b>Δ</b> Country (W)
<b>Result</b>				
Revenue with Dividends	(f) € 850,000			
Interest Revenue		(e') € 1,000,000	(d) € 1,000,000	
(-) Interest Expense			(e') € 1,000,000	(d) € 1,000,000
(=) Results	€ 850,000	€ 1,000,000	€ -	-€ 1,000,000
(-) Taxes on profits 15%		(h) € 150,000		
(-) Distributed Dividends		(f) € 850,000		

(e') – Interest payment of 1,000,000 euros from β to α, which are treated as interest both in countries Y and K.

(h) -Tax rate on profit.

**Panel B**

Both jurisdictions classify hybrid financial instruments as owners' equity

	$\lambda$ Country (X)	$\alpha$ Country (K)	$\beta$ Country (Y)	$\Delta$ Country (W)
<b>Result</b>				
Revenue with Dividends	(f) € 850,000	(e') € 850,000		
Interest Revenue			(d) € 1,000,000	
(-) Interest Expense				(d) € 1,000,000
(=) Results	€ 850,000	€ 850,000	€ 1,000,000	-€ 1,000,000
(-) Taxes on profits 15%			(h) € 150,000	
(-) Distributed Dividends		(f) € 850,000	(e') € 850,000	

(e') – Payment of dividends of 850,000 euros from  $\beta$  to  $\alpha$ , which are treated as distributed dividends.

(h) -Tax rate on profit.

It is important to note that the economic rationale seeking tax reductions through the use of HFI would be empty in both panels, since the payment values would be taxed in either country **K** or **Y**, whether hybrid instruments are considered to be financial liabilities or equity instruments.

This observation confirms comments made by the OECD (2012) that the non-taxation of hybrid instruments can occur due to the existence of asynchronous rules between countries. Similarly, we may presume that this issue is broader and also affects other jurisdictions that are not member states of this organization, thus reinforcing the premise that the taxation of hybrid financial instruments must be understood as an object to be studied and regulated by an international group, following the efforts made by the Base Erosion and Profit Shifting (BEPS) project which aims to provide clear international solutions to counteract tax planning strategies that exploit loopholes and flaws in legislative systems to artificially change taxation on profits and to tax this item in more favorable locations (OECD, 2014).

## 4 POTENTIAL IMPACT OF ACCOUNTING FOR HYBRID INSTRUMENTS ON THIN CAPITALIZATION RULES

In general, thin capitalization rules are intended to limit interest deductibility when liability with related parties is excessive in relation to its capital. For Custódio and Aquino (2010), thin capitalization policies set out to stimulate the permanence of long-term capital (permanent investment) vis-à-vis the inhibition of reporting artificial interest expenses.

Klostermann (2007, p. 13) established the following:

It is a fact that the conditions for, definitions of and exceptions from thin capitalization rules vary from country to country. The aim of every set of regulations on thin capitalization, however, is the same: the avoidance of excessive debt financing, especially through shareholders, and of the corresponding loss of tax revenue in the source country.

Piltz (1996) clarifies that the limits for thin capitalization are generally set forth by means of financial indicators, which compute the ratio between indebtedness with the overseas affiliated company and its respective equity interest in the local subsidiary, as shown in Equation (1):

$$TCI = \frac{\sum_{j=1}^n LFI_j}{\sum_{k=1}^n EFI_k} \quad Equation (1)$$

Where: TCI denotes the thin capitalization indicator.  $\sum_1^n LFI$  represents the total monetary balance of loans obtained from foreign investors, considering the first to the  $n^{th}$  contract. Finally,  $\sum_1^n EFI$  indicates the total equity interest held by foreign investors who have loans with the local subsidiary, considering the restriction  $0 < EFI \leq Capital$ .

According to Ernst and Young (2010), the values admitted for the thin capitalization indicator (TCI) vary according to the rules of each location. For example, in Luxembourg a maximum value of approximately 5.6 is allowed. That is, for every euro invested in the company's capital by foreign shareholders, it is possible to allocate 5.6 euros as loans linked to foreign shareholders. In the United States of America, this ratio is 1.5. Values that exceed these proportions will potentially be set aside and considered as non-deductible for the purpose of taxing profit. For an expressive range of jurisdictions, the maximum value for TCI is in the order of 3 (3:1).

It is worth noting that thin capitalization rules are based, in general, on the definitions of owners' equity and financial liabilities established through accounting standards (Klostermann, 2007). Thus, if a given hybrid security is admitted as an equity instrument for the purposes of the financial statements, it will probably be understood within the scope of the thin-cap rules, unless the tax rules determine a different treatment.

For instance, let us consider that company  $\mu$  based in jurisdiction Q—where there are no specific rules for taxing hybrid financial instruments—has loans with its foreign investor  $\tau$  in the amount of 15 million euros. The current equity interest of  $\tau$  in  $\mu$  is 5 million euros. Therefore, if we apply Equation (1), we would obtain a TCI of 3 (15/5). This ratio indicates that for every euro invested by  $\tau$ , there are another 3 euros taken as debt related to  $\mu$ .

Let us assume that the thin capitalization rules of jurisdiction Q allow for a maximum TCI of 2(2:1), and depending on this imposition, the group decides to exchange part of the debt securities in the amount of 7 million euros for hybrid financial instruments, which shall be delivered to  $\tau$ .

These hybrid securities will be reported by  $\mu$  in the balance sheet, because they are based on the company's understanding that these securities have economic and financial characteristics that are closer to the concept of equity instruments than debt securities, although the motivation for this exchange arose from the need to reduce the rate of thin capitalization.

If we apply Equation (1) again, it is possible to verify that after issuance of the hybrid instruments, the TCI of company  $\mu$  was reduced to 1.6 (8/5).

**Table 4**

Conversion of debt securities to hybrid financial instruments

	Moment 0	Moment 1
	$\mu_{\text{Country (Q)}}$	$\mu_{\text{Country (Q)}}$
<b>Asset</b>		
- Cash and Equivalents	€ 20.000.000	€ 20.000.000
- Fixed	€ 25.000.000	€ 25.000.000
<b>Liability</b>		
Loans with $\tau$	€ 15.000.000	(a) € 8.000.000
<b>Owners' Equity</b>		
- Capital	€ 30.000.000	€ 30.000.000
- Hybrid Instrument		(a) € 7.000.000
Thin Capitalization Index (TCI)	3,0	1,6

(a) Conversion of debt securities to hybrid financial instruments.  
Source: Authors (2020).

Even without increasing the capital of organization  $\mu$ , it is possible to observe a dilution of the TCI, thus ruling out the possibility of setting aside interest on loans, whose counterpart is foreign investor  $\tau$ . Similarly, because there are no specific rules in jurisdiction Q for the taxation of hybrid financial instruments, the issuer of these securities may feel encouraged to treat the considerations for those securities as tax-deductible expenses.

In the hypothetical example shown in Table 4, the costs of issuing hybrid instruments were not taken into account for the same reasons as in Table 1.

We can therefore conclude that the existence of rules to prevent thin capitalization without standards regulating the taxation of hybrid financial instruments constitutes an incomplete set of regulations that can even stimulate the use of this type of financial instrument by those seeking tax planning with debatable consequences.

## 5 FINAL CONSIDERATIONS

This study assessed how accounting records for hybrid financial instruments could have an impact of a tax nature. More specifically, in the context of investments on international platforms, we observed the interrelationships in the accounting of hybrid instruments, as well as the impact of such assessments on the advent of corporate thin capitalization.

Within the scope of the justifications which led to the development of this study, we refer to how the tax benefits derived from multinational corporate structures could provide incentives for the issuance of hybrid financial instruments, which, taken as mechanisms for tax management, could lead to a reduction in the taxable profits of companies using this type of capital-raising.

Considering the existence of potential asymmetries between the existing tax systems in different jurisdictions, we found that the assessments for these securities allow for the considerations arising from these papers to be taken as deductible

interest expenses in the countries of origin of the payment and even reach foreign investors as dividends exempted from taxation. This finding corroborates statements made by the OECD (2012) in which the organization indicates that the dysfunctions between the tax systems can provide for the non-taxation of the returns generated by the hybrid securities.

As for thin capitalization rules, we identified that hybrid instruments can aid with the artificial dilution of the TCI, more notably, by converting legitimate debt securities into hybrid instruments that are eligible for reporting in the balance sheets. This finding indicates that the regulations that prevent the reduction of taxable profit through artificial interest expenses become less efficient when no specific rules for taxing hybrid instruments have been created.

Additionally, we reiterate the importance of the IASB initiative for starting a project for the study and the potential issuance of a standard that aligns the accounting treatment of financial instruments with equity characteristics among the countries that adopt the IFRS. After all, it is precisely in the contractual misalignment that these instruments should be treated as financial liabilities or equity instruments where there exists minimally questionable tax practices concerning their opportunities.

In light of the disparities provided herein, we can conclude that, although hybrid financial instruments are important alternatives for capital-raising, especially considering the new demands of the allocators of economic resources, tax rules need to determine specific tax treatments for these instruments. In a scenario where there is no tax treatment that excludes any benefits from the use of hybrid financial instruments, there will be widely reported incentives to use this type of contract for the purpose of reducing the tax burden through devices founded on the asymmetries of treatment between jurisdictions.

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### AUTHORS' CONTRIBUTIONS

Contributions	Eduardo Flores	Eliseu Martins	Nelson Carvalho	Guillermo Oscar Braunbeck
1. Idealization and conception of the research subject and theme	✓	✓	✓	✓
2. Definition of the research problem	✓	✓	✓	✓
3. Development of Theoretical Platform	✓	✓	✓	✓
4. Design of the research methodological approach	✓	✓	✓	✓
5. Data collection				
6. Analyses and interpretations of collected data				
7. Research conclusions	✓	✓	✓	✓
8. Critical review of the manuscript	✓	✓	✓	✓
9. Final writing of the manuscript, according to the rules established by the Journal.	✓	✓	✓	✓
10. Research supervision	✓	✓	✓	✓