Singapore issues guidance on income tax treatment of hybrid instruments

On 19 May 2014, the Inland Revenue Authority of Singapore (IRAS) issued guidance on the income tax treatment of hybrid instruments.\(^1\) This Alert summarizes the two-step approach adopted by the IRAS on the characterization of hybrid instruments and the corresponding Singapore income tax consequences for the issuer and the investor.

Detailed discussions

Two-step approach

1. **Step 1 - Legal form:** If the legal terms of the instrument indicate ownership interests in the issuer, then the hybrid instrument will generally be characterized as equity.

2. **Step 2 - Facts and circumstances:** If the legal form is not indicative of or does not reflect the legal rights and obligations, the IRAS will examine the facts and circumstances surrounding the instrument, as well as a combination of factors. The IRAS has listed (though not limited to) the following eight factors to be taken into consideration:
   a. Nature of interest acquired
   b. Right to participate in issuer’s business
   c. Voting rights conferred by the instrument
   d. Obligation to repay the principal amount
   e. Payout
   f. Investor’s right to enforce payment
   g. Classification by other regulatory authority
   h. Ranking for repayment in the event of liquidation or dissolution

The characterization of the hybrid instrument will be determined based on a combination of the above factors and the facts and circumstances of the case.
In addition, the IRAS will also consider the following:

- Irrespective of characterization for accounting purposes, the IRAS will follow the approaches outlined above to determine the characterization of the hybrid instrument.

- Where the hybrid instrument is issued by a foreign issuer, the IRAS will also examine the facts and circumstances surrounding the characterization of the hybrid instrument in the country of the foreign issuer.

- Where the issuer of the hybrid instrument is a Singapore branch, the IRAS will consider both the facts and circumstances surrounding the characterization of the hybrid instrument in Singapore as well as the country where the head office is located. If there is a mismatch in classification of the hybrid, the IRAS will evaluate the basis for the different characterization, taking into consideration the specific facts of the case before determining the character of the instrument for Singapore tax purposes.

**Tax treatment of hybrid instrument**

<table>
<thead>
<tr>
<th>Hybrid instrument characterized as equity</th>
<th>Issuer</th>
<th>Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution from the issuer</td>
<td>Dividend payment (not tax deductible)</td>
<td>Dividend income or Real Estate Investment Trusts (REITs) distribution</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th>Hybrid instrument characterized as debt</th>
<th>Issuer</th>
<th>Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distribution from the issuer</td>
<td>Interest payment (tax deductible if deductibility rules are met)</td>
<td>Interest income (taxable unless specifically exempted)</td>
</tr>
</tbody>
</table>

**Administrative and other matters**

Issuers may, before the issuance of the instrument, seek an advance ruling from the IRAS on the characterization of the hybrid instrument.

Both issuers and investors are expected to maintain the relevant documents relating to the hybrid instruments, which are to be provided to the IRAS upon request.

In addition, the IRAS may disregard or vary arrangements and make adjustments, as it considers appropriate, if the hybrid instrument is issued in connection with a tax avoidance arrangement.

As there is no effective date mentioned in the e-Tax guide, it appears that the tax treatment discussed may also apply to hybrid instruments existing as at 19 May 2014.

The IRAS appears to still treat redeemable preference shares as equity for tax purposes.
Endnotes

1. Examples include redeemable preference shares, convertible bonds, perpetual notes and profit participating loans.

2. The Singapore branch must meet the following requirements to be regarded as a Singapore-based issuer:
   a) The instrument is issued solely and separately by (and not through) the branch
   b) The instrument is reflected in the branch's accounts
   c) The proceeds are used by the branch, and
   d) The instrument is not issued by the head office and transferred to the branch.

3. If the dividend is paid by a Singapore resident company then it is a one-tier dividend, which is tax exempt. If the dividend is a foreign dividend received in Singapore, it is subject to tax but may qualify for tax exemption under the foreign-sourced income exemption scheme.

4. The taxability of a REIT's distribution would generally depend on the underlying receipts from which the distribution is made and the profile of the investors.

For additional information with respect to this Alert, please contact the following:

**Ernst & Young Solutions LLP, Singapore**
- Chung-Sim Siew Moon +65 6309 8807 siew-moon.sim@sg.ey.com
- Russell Aubrey +65 6309 8690 russell.aubrey@sg.ey.com
- Chong Lee Siang +65 6309 8202 lee.siang.chong@sg.ey.com
- Stephen Bruce +65 6309 8898 stephen.bruce@sg.ey.com

**Ernst & Young LLP, Asia Pacific Business Group, New York**
- Chris Finnerty +1 212 773 7479 chris.finnerty@ey.com
- Kaz Parsch +1 212 773 7201 kazuyo.parsch@ey.com
- Bee-Khun Yap +1 212 773 1816 bee-khun.yap@ey.com
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