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An Analysis of the Substantive Scope of National Thin Capitalization Rules with special Emphasis on Hybrid Financial Instruments

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ABSTRACT

The choice of corporate finance is an important source of tax planning opportunities for multinational companies. Investing companies have to be aware of inconsistent tax classification of equity and debt between countries in particular. Additionally, thin capitalization rules have to be taken into account. In response to changing corporate needs the present paper focuses on the tax consequences of hybrid financial instruments. Only some literature exists on cross-border hybrid finance. Especially the linkage between the two areas – hybrid finance and thin capitalization – both on a national and international level had to be dealt with academically. The paper analyses the substantive scope of thin capitalization regimes in general and in detail. The main finding is that the tax consequences of hybrid instruments reverse when used in thin capitalization situations and that traditional tax policy has to be reconsidered.

KEYWORDS

Corporate Finance, Hybrid Financial Instruments, Thin Capitalization Rules, Corporate Taxation

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I. INTRODUCTION

Roughly spoken a company may be financed by equity or by loans. As a rule, the choice of the means of financing is up to the shareholders. Apart from economic and legal circumstances, tax motives may lead to the decision of a company's shareholder to use loan capital rather than equity (Lüthi, 1991: 446; Knobbe-Keuk, 1992: 405). Indeed, the tax treatment of a company and its shareholders differs significantly according to whether the raised capital is equity or loan capital: whereas the return on an equity investment (dividend distribution) forms part of the company's taxable profit, the return on a loan investment (interest payment) is generally regarded as deductible expense in computing the taxable profit (OECD, 1987: 9; McDaniel and McMahon and Simmons, 1999: 497). Financing structures with a small proportion of equity are therefore generally more advantageous as they reduce a company's tax burden not only in a national but possibly also in an international context[i]. However, from a legal or economic point of view, e.g. in connection with 'Basel II', equity-strong financing may be required. In this regard, the use of hybrid financial instruments is the source of interesting tax planning techniques (Herzig, 2000: 483; Eberhartinger and Six, 2006: 5). Hybrid financial instruments can be designed in a way that they provide capital that is economically similar to equity but taxed as debt (McDaniel and McMahon and Simmons, 1999: 497). Through the use of hybrid instruments inconsistencies in national tax systems can be exploited and double non-taxation may arise.

In recent years, the free choice of financing by shareholders is increasingly restricted (Lüthi, 1991: 446). More and more countries tend to introduce so-called thin capitalization rules to restrict excessive (shareholder-) debt financing of companies (Endres, 2006: 257 et seq.). Tax authorities want to detect disproportionate use of loan investments and prevent a potential loss of tax income with regard to cross-border financing structures (e.g., Van Raad, 1986: 178; Lüthi, 1991: 447; Gouthière, 2005: 367). Thin capitalization rules are of special interest when companies use hybrid financial instruments to finance their activities in a tax-minimizing way. Hybrid financial instruments may come under the substantive scope of national thin capitalization rules and may be included in the computation of a safe haven. For this very reason a qualification of hybrid instruments either as equity or as debt is essential. Thin capitalization rules, however, may stipulate special classification criteria. In addition to a possible inclusion of hybrid instruments in the calculation of the safe haven the tax consequences of the thin capitalization rule may also be applied to debt-alike hybrid instruments. Therefore, in thin capitalization situations the favourable tax treatment of debt-alike hybrid financial instruments may be lost and other group financing structures may be influenced negatively. Equity-alike hybrid instruments may become more advantageous.

The focus of this paper rests on the taxation of cross-border finance of multinational companies. The taxation of partnerships will not be part of the analysis. The use of abnormal or excessive rates of interest will not be dealt with in this paper either. It is the aim of this paper to address the above-mentioned issues and call attention to the fact that well-known tax planning techniques (Merks, 2006) possibly have to be reconsidered in corporate tax planning. The theoretical analysis will be completed by the country-specific regulations of six countries. The countries chosen are Austria on the one hand, being the home country of this research project, and its most important capital import and capital export countries.[ii] An illustrative example will help to demonstrate the tax effects of corporate cross-border finance.

II. TAX ASPECTS OF CORPORATE FINANCE

It is important to point out that tax motives may not be the main or only reason leading to the financing decision of multinational enterprises (OECD, 1987: 9 et seq.; Endres, 2006: 256). Legal and economic conditions also must be taken into account (Hosson and Michielse, 1989: 476; OECD, 1996: 90). However, tax is cost and cost means profit reduction. Tax minimization therefore directly corresponds to the managerial aim of profit maximization. Shareholders have to structure their financing activities in order to minimize the tax burden (Endres, 2006: 258).

Basically there are two methods of finance: equity and debt. Shareholders of a company are generally free in the choice of finance (OECD, 1987: 9; Bittker and Eustice, 2000: 4-4; Gouthière, 2005: 367).[iii] Because of various reasons shareholders tend to use debt financing rather than equity financing (Piltz, 1996: 92). In fact, equity is risk capital. An equity investment leads not only to a change in holdings and voting rights but also to an increase in responsible capital. While an equity investment offers entrepreneurial independence and additional creditworthiness, the formal requirements of an equity investment are enormous. The advantages of a debt investment are e.g. a lower risk assumption, a return on investment independent of the result of the company, possible exploitation of the leverage effect etc. (Piltz, 1996: 92; Endres, 2006: 256). For a clear distinction between equity and debt contributions see table 1.

Classification criterion	Equity	Debt
Legal position	(co-)ownership rights	creditor rights
Entrepreneurial influence	normally full information, control and voting rights	normally no information, control and voting rights
Substantial holding		
Profit participation	sharing in profits and losses; participation in hidden reserves and liquidation proceeds	normally fixed return independent of profits and losses
Liability	at least amounting to the share	no liability
Collateral	no collateral	(preferential) collateral
Order in case of insolvency	subordinated	preferential
Term of capital commitment	no fixed repayment provision	fixed repayment provision
Compensation		
Right to compensation	residual right	nominal right
Type of compensation	dividend payment	interest payment
Tax classification	non deductible profit distribution	deductible interest expense

Table 1 *Classification Criteria of Equity and Debt*[iv]

Due to changing corporate needs the simple differentiation between debt and equity does not mirror the diversity of finance any more (e.g., Leitinger, 2005; Hudetz, 2005; Müller-Känel, 2004). Many financial instruments show elements of both categories or can be converted from one type to the other (Duncan, 2000: 23; Kahn/Lehman: 2001, 502 et seq.; Bittker and Eustice: 2000, 4-21). These financial instruments are called 'hybrid financial instruments' or 'mezzanine finance'.[v] Hybrid financial instrument are financial instruments that have economic characteristics that are inconsistent, in whole or in part, with the classification implied by their legal form (Duncan, 2000; see table 2).

Classification criterion		Hybrid Financial Instruments
Legal position		inconsistent; possibly conversion right
Entrepreneurial influence		normally few information, control and voting rights
Substantial holding	Profit participation	(interest) return dependent on profit and losses
	Liability	up to the amount that is converted into equity
	Collateral	no collateral; subordination clause
	Order in case of insolvency	preferential compared to shareholders; subordinated compared to creditors
Term of capital commitment		normally long-term
Compensation	Right to compensation	via equity-kicker
	Type of compensation	inconsistent
	Tax classification	normally deductible expense

Table 2 *Classification Criteria of Hybrid Financial Instruments*[1]

Hybrid financial instruments can be tailored to meet the needs of every investor. The spectrum of hybrid financial instruments ranges from corporate shares with features typically associated with loans and loan contracts with conditions typical of equity investments. The more debt characteristics are included in an instrument, the more likely a classification as debt for tax purposes is and vice versa (Helminen, 2004: 57). However, countries weigh characteristics differently and are so unanimous about classification. In general, debt-equity hybrids include e.g. preference shares, silent partnerships, jouissance rights, participation bonds, convertible bonds, warrant bonds and profit participation loans (table 3).

[1] See also Bittker and Eustice: 2000, 4-23 et seq.

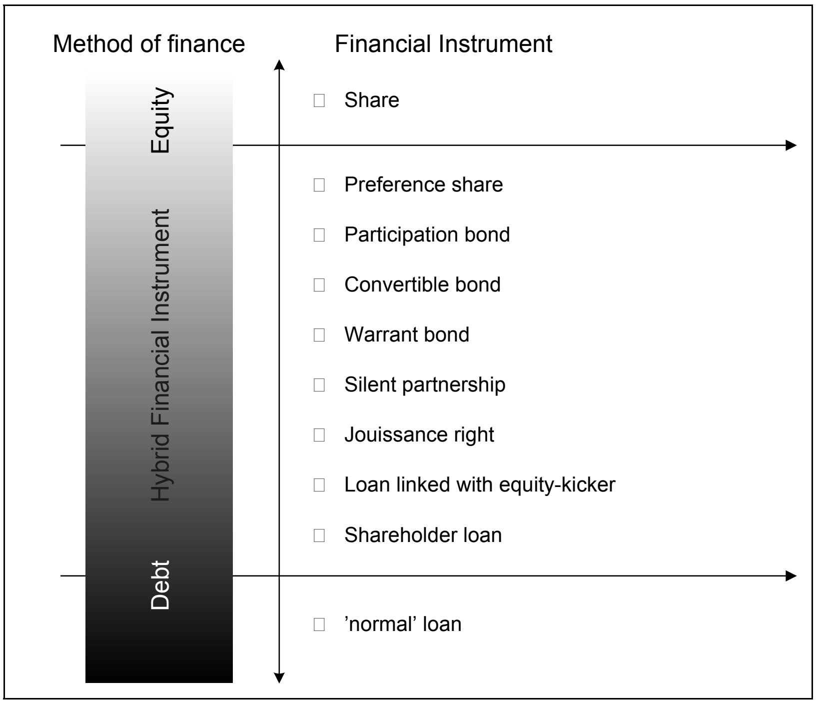

Table 3 *Spectrum of Hybrid Financial Instruments*

A basic problem in connection with business finance is the fact that the terms 'equity' and 'debt' are not defined uniformly in national as well as international corporate, accounting and tax law and they do not imply the same legal consequences. As a matter of fact the classification of hybrid instruments is even more complicated. Hybrid instruments cannot be clearly attributed to either equity or debt. Only few of these instruments are regulated by law. For tax purposes, however, a clear attribution of financial instruments to either equity or debt is crucial. Due to the lack of tax neutrality in finance (Kofler and Payerer, 2004: 54; Seibold, 2002: 164) not only the inflow but also the return on investment is treated differently for tax purposes (Kahn and Lehman: 2001, 41 et seq.). The return on equity investments is in principle subject to double taxation (Posin and Tobin: 2005, 86; Rose and Chommie: 1994, 522): once at the level of the profit generating company and once at the level of the shareholder in case of distribution. Dividends are part of a company's taxable profit, which means that they do not reduce the company's taxable base. At the level of the shareholder dividends are subject to capital gains tax. The return on loan investments on the contrary is generally taxed only once at the level of the shareholder. At the level of the lending company interest is a tax-deductible expense leading to a reduction in the corporate taxable base. Additionally, refinancing costs are tax deductible at the level of the shareholder. In conclusion, debt financing is generally more favourable than the contribution of equity capital (Kahn and Lehman: 2001, 45).

Tax classification criteria of hybrid instruments are not necessarily congruent with economical or legal criteria and depend on a country's legislation, jurisdiction and administrative practice (OECD, 1987: 14). Different criteria, e.g. the performance-dependency of payments, the bearing of risk etc., must be interpreted and carefully weighted in order to do a final classification. The differences in classification are an important source of corporate tax planning opportunities and risks (Helminen, 2004: 56). In cross-border situations, hybrid instruments may be treated as debt in the source state and as equity in the country of residence of the shareholder and vice versa. The return on the investment would be deductible in the source state and exempt from tax in the state of residence of the shareholder. In the opposite case, the return on the hybrid instrument would be treated as a non deductible profit distribution in the source state and as a taxable interest payment in the country of residence of the shareholder (Herzig, 2000: 485). Disregarding anti-avoidance rules, e.g. 'subject-to-tax-clauses' (Schilcher, 2004: 34 et seq.), double non-taxation or double taxation may be the result.

III. THIN CAPITALIZATION RULES

A. THE CONCEPT OF THIN CAPITALIZATION RULES

The term 'thin capitalization' simply refers to a company's capital structure which is characterised by a high proportion of (shareholder-) debt to equity. Expressions like 'hidden equity capitalisation' or 'shareholder debt financing' are often used synonymously (OECD, 1987: 11).

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 (e.g., Knobbe-Keuk, 1992: 408; Grotherr, 1995: 52; Thömmes, 2004: 126; Endres, 2006: 258). In cross border situations the main portion of the tax revenue from interest payments is realised in the country of residence of the lender. The main portion of the tax revenue from dividend payments on the contrary is realised in the source country. Therefore tax administrations began to introduce thin capitalization rules. The preliminary question of thin capitalization rules is, whether or not the payment concerned derives from a loan or equity contribution (OECD, 1987: 13). In the beginning thin capitalization rules consequently have been applied to cross-border situations only. Due to developments in European Law[vi], however, several countries broadened the scope of their thin capitalization rules and included domestic situations also (e.g., Obser, 2005: 7).

B. LEGAL BASIS OF THIN CAPITALIZATION RULES

Measures taken against thin capitalization of companies are either based on general tax rules or regulated by specific law. Those countries which penalize thin capitalization with general tax rules rely on principles such as the substance over form principle, the general arm's length principle or the abuse of law concept (Piltz, 1996: 102 et seq.). Normally these principles are derived from a country's jurisdiction or administrative practice and used only in extreme cases (e.g. Austria).

Country	Type of Thin Capitalization Rule		Introduction
	Specific law	General Rule Administration Practice	
Austria	-	Art 8 (2) CTA	-
Germany	Art 8a CTA	Art 8 (3) 2nd sentence CTA	1994
Czech Republic	Art 25 (1)(w) ITA	-	2005[a]
Hungary	Art 8 (1)(j) und (5) CDTA	-	1992
Netherlands	Art 10 d Wet Vpb	-	2004
United Kingdom	Schedule 28 AA ICTA 1988 [s. 209 ICTA 1988]	-	2004[a]

[a] new rule

Table 4 *Legal Basis of Thin Capitalization Rules of Different Countries*

Countries with particular rules on thin capitalization specify a certain unobjectionable debt to equity ratio (fixed-ratio-approach, see e.g. McDaniel and McMahon and Simmons, 1999: 514 et seq.) or reclassify interests paid to non-residents in general. Sometimes countries grant exceptions to the basic rule for certain types of activities and groups of companies. In some countries thin capitalization rules are applied only to particular industries, shareholders, managing directors or holding companies (Piltz, 1996: 101 et seq.). Mostly countries pursue a fixed-ratio-approach and additionally refer to the arm's length principle when applying their thin capitalization rule (table 5) (see e.g. Kessler and Obser, 2004).

Country	Fixed Debt/Equity Ratio	General Anti Abuse Approach	Arm's Length Test	Threshold/Tax Exemption
Austria	-	x	x	-
Germany	1,5:1	-	x[a]	250.000 € / -
Czech Republic	4:1 / 6:1	-	-	-
Hungary	3:1	-	-	-
Netherlands	3:1/ group ratio test	-	-	- / 500.000 €[b]
United Kingdom	-	-	x	-

[a] no arm's length test for profit-dependent return
[b] not in connection with group ratio test

Table 5 *Country-specific Thin Capitalization Approaches*

C. TAX CONSEQUENCES OF THIN CAPITALIZATION RULES

The tax consequences at the level of the subsidiary in the source country can be divided into three categories (Piltz, 1996: 119 et seq.):

1. reclassification of debt as equity,
2. non-deductibility of interest,
3. reclassification of interest as (hidden) profit distribution.

As a result, all thin capitalization rules lead to the non-deductibility of the payment on 'bad' debt at the level of the subsidiary. Thus an increase in the taxable base of the subsidiary has to be expected.

The country of residence of the parent company generally has two options in treating the return on investment: tax it as interest or tax it as profit distribution. If the country of residence does not agree with the tax treatment in the source country and taxes the return on the debt investment as regular interest, double taxation will be the result. If the country of residence, on the other hand, accepts the characterisation of the source country and makes a corresponding adjustment of the tax burden at the level of the parent company – normally by granting an exemption from tax -, single taxation can be achieved. The country of residence, yet, will lose part of its tax revenue.

Country	Tax Consequence		Corresponding Adjustment in Country of Residence					
	(permanent) Reclassification in Dividends	(permanent) Non-Deductibility	AUT	GER	CZ	HU	NL	UK
Austria	x			no	yes	yes	yes	-
Germany	x		no		no	no	yes	yes
Czech Republic	x		no	yes		no	no	yes
Hungary		x	no	no	no		yes	no
Nehterlands		x	no	no	no	yes		yes
United Kingdom		x	no	no	no	yes	yes	

Table 6 *Tax Consequences of Thin Capitalization Rules* (see Zielke, 2006)

D. SUBSTANTIVE SCOPE OF THIN CAPITALIZATION RULES

1. Preliminary remarks

Countries with special thin capitalization regulations generally follow the concept of a fixed debt to equity ratio. Within certain limits the return on the debt financing remains deductible; the taxpayer rests in a ‘safe haven’. The unobjectionable debt-equity ratio varies from country to country. For the application of thin capitalization rules either the level of debt of the lending company in total or against individual shareholders or certain groups of shareholders is relevant. Some countries also grant a certain threshold. If the debt financing does not attain a minimum amount, the thin capitalization rule is not applicable. Groups of companies or certain industries may be subject to different treatment in this context. As the taxpayer normally has to bear the burden of proof, the definition of the respective variables has to be examined in detail. Firstly, the question has to be answered, what the relevant equity capital is. Secondly, the relevant loan capital has to be defined. Finally, it must be determined if hybrid instruments are also included in the substantive scope of thin capitalization rules.

As a rule, the more equity components and the less debt components a company’s capital structure has, the more favourable the debt-equity ratio and consequently the effects of a thin capitalization will be. With reference to the discussion in chapter II this seams quite contradictory. The conclusion of the previous discussion was that from a tax perspective debt financing is generally more advantageous than equity financing. In thin capitalization situations, however, it is exactly the opposite way round. If a company uses debt financing structures beyond the safe haven, the result in the source country will definitely be the denial of the interest deduction. This is exactly what tax administrations want: tax the return on investments originally classified as debt as profit distributions in order to assure single taxation in the source country. The problem arises when crossing the borderline. If the resident country is willing to treat the payment as dividends also, the overall tax burden will be identical with the tax burden of straight equity finance. If the country of residence, on the contrary, is not willing to follow the classification of the source country the same economic substance will be taxed twice. For this reason, the use of pure equity financing is more favourable, especially more certain in its consequences. The very same is true for the use of hybrid financial instruments in thin capitalization situations.

2. Equity Definition

The meaning of equity in thin capitalization rules is largely consistent with the meaning of equity in commercial balance sheets. The authorized share capital, the surplus capital retained, retained earnings from previous years and untaxed reserves are typical equity components (Piltz, 1996: 110) and therefore generally considered in the calculation of the debt-equity ratio. The amount of equity is e.g. calculated at the previous year-end, the actual year-end or in a given year.

3. Debt Definition

Every set of regulations on thin capitalization clearly stipulates what is to be considered as debt. Depending on the country’s regime the following types of loan capital will or will not be included in the determination of the level of debt (see Piltz, 1996: 106 et seq.):

1. Ordinary loans: ordinary loans with arm’s length interest rates and fixed repayment obligations are generally classified as debt.

2. Non-interest-bearing loans: as long as no interest payment is made, a country's tax revenue cannot be lost and therefore an inclusion of non-interest-bearing loans in the computation of the level of debt does not make a sense.
3. Short-term-loans: the treatment of short-term-loans is quite inconsistent.
4. Back-to-back loans[vii]: as a rule, this form of loan financing comes under the scope of all thin capitalization rules.
5. Third party loans: if a third party has the right to take recourse on the shareholder based on a surety, guarantee, statement of support etc. the loan will generally increase the level of debt. Some countries, however, differentiate.

The relevant amount of debt is either the amount of debt at year-end, an average annual amount of debt, the highest amount of debt in a given year, a choice between the highest and the average amount of debt or some other figure.

4. Hybrid Financial Instruments

Thin capitalization rules typically control shareholder loans and high-debt equity ratios respectively. Nevertheless hybrid instruments[viii] may also fall under the substantive scope of thin capitalization rules. De Hosson and Michielse (1989: 477) see a possible manifestation of thin capitalisation in hybrid financial instruments when shareholders provide capital that '*is essentially equity capital in prima facie clothing as a loan*' (see also Lüthi, 1991: 446). Even if hybrid instruments do not come under the substantive scope of thin capitalization rules they may be included in the computation of the safe haven. Due to the personal scope of certain thin capitalization rules, not only hybrid finance through shareholders but also through third parties must be taken into account. Table 7 gives an overview of the substantial scope of thin capitalization rules of selected countries (Gassner, 1996; Watrin and Lühn, 2004; Smit and Smith, 2005; Végh and Szűcs, 2005; Nias and Purcell, 2005; Trezziová and Fekar, 2005).

Country	Substantive Scope of Thin Capitalization Rules					
	'Normal' Loan	Short-Term Loan	Interest-Free Loan	Back to Back Loan	Third Party Loan with Recourse[a]	**Hybrid Financial Instrument**
Austria	-	-	-	-	-	**-**
Germany	x	-	x	x	x	**x**
Czech Republic	x	-	-	-	-	**-**
Hungary	x	-	-	-	-	**-**
Netherlands[b]	x/x	-/x	-/x	-/x	-/x	**-/x[c]**
United Kingdom	x	-	-	x	x	**-[d]**

[a] e.g. certificate of bond, letter of comfort

[b] two different methods of calculation dependent on the test chosen:
a) safe haven test: net debt-calculation according to tax balance sheet items; only 'money loans' are included
b) group ratio test: no net debt-calculation; all liabilities of the commercial balance sheet have to be included

[c] Art 10 (1)(d) ITA - specific rule for 'hybrid loans': neither equity nor debt; interest non-deductible when equity-hybrid

[d] International Arbitrage Rules

Table 7 *Substantive Scope of Thin Capitalization Rules in different Countries*

In any case, the classification of hybrid instruments for thin capitalization purposes as either debt or equity is decisive. In most cases the classification criteria are consistent with the general classification criteria in tax law, provided that they exist. Sometimes, however, traditional tax classification rules are insufficient. Debt-alike hybrid instruments do typically have a negative impact on the taxation of companies in thin capitalization situations. If a debt-alike hybrid instrument e.g. is not included in the substantive scope but nevertheless in the calculation of the safe haven, the taxation of 'regular' (shareholder) loan capital may be influenced negatively. If a debt-alike hybrid instrument is included in the safe haven calculation and in the substantive scope, such hybrid instruments do not only have negative influence on the level of debt but also lose their own tax attractiveness. Equity-alike hybrid instruments, on the contrary, always have a positive effect on the taxation of thinly capitalized companies. The following table (table 4) shows possible constellations of hybrid instruments in thin capitalization situations.

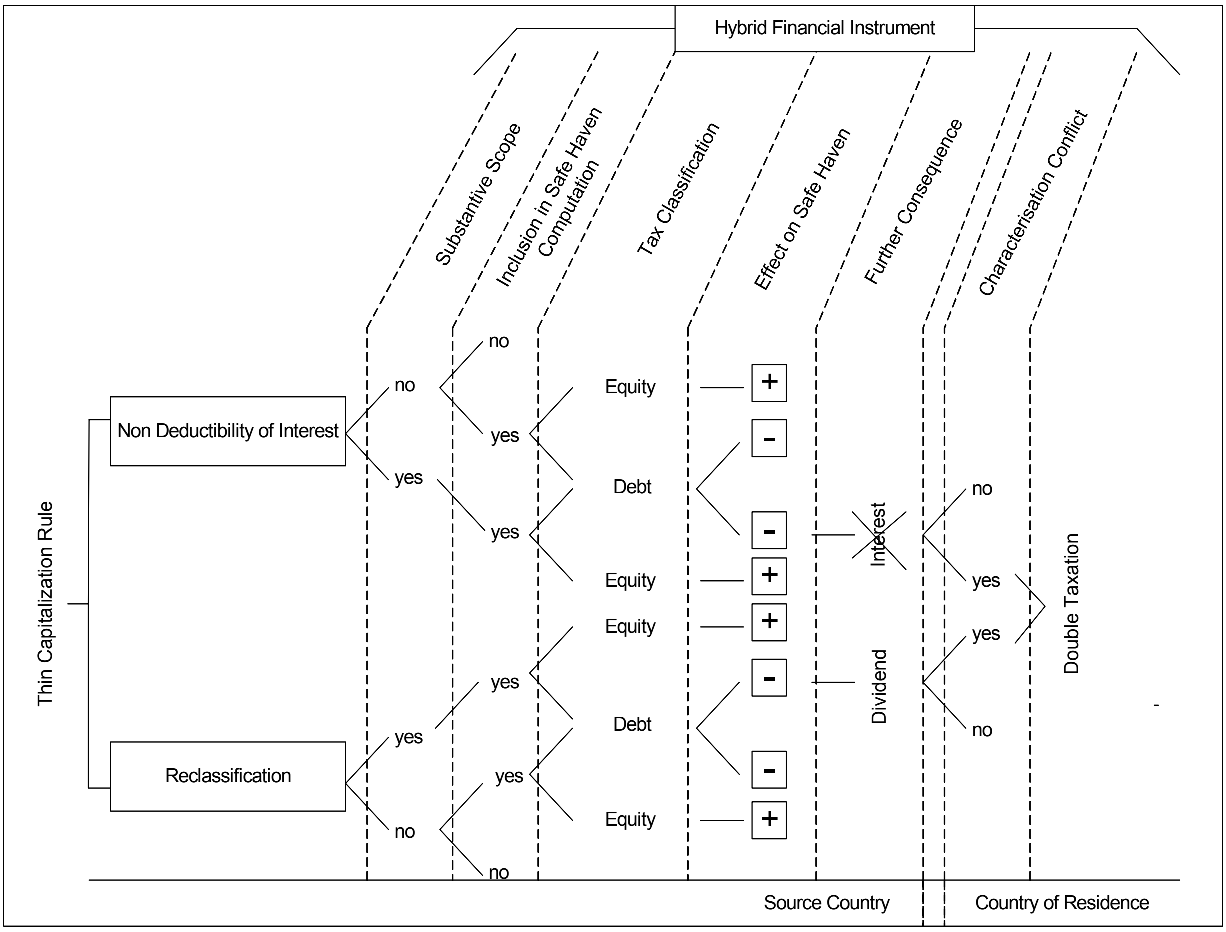

Table 8 *Possible Consequences of Hybrid Financial Instruments in Thin Capitalization Situations*

IV. COMPARISON OF TAX BURDEN – AN ILLUSTRATIVE EXAMPLE

The following two tables (table 9 and 10) shall illustrate the tax consequences of cross-border group-finance discussed in chapter III. The source country or the country of residence of the subsidiary is Germany. The country of residence of the parent company is Austria. Whereas Germany pursues a strict thin capitalization regime (e.g., Obser, 2005), according to Austrian Corporate Tax Act a company is supposed to be thinly capitalized only in extreme cases (Gassner, 1996). The following assumptions have been made:

1. Only corporations are included;
2. The parent company has a holding of 100 % of the subsidiary;
3. The rate of interest is at arm’s length;

4. In case of loan financing the EBIT is used up by interest payments;
5. Only income taxes are considered and
6. Refinancing costs at the level of the parent company are not taken into account.

Source Country: Germany **Country of Residence: Austria**				
		Shareholder Loan		
Method of Finance	**Equity**	GER: Interest[a] AUT: Interest	GER: Art 8a[c] AUT: Dividends	GER: Art 8a[c] AUT: Interest
Level of Subsidiary in GER				
EBIT	500,00	500,00	500,00	500,00
Interest on Loan		-500,00	-500,00	-500,00
+ Reclassified Interest			500,00	500,00
EBT	500,00	0,00	500,00	500,00
German Trade Tax (16,67 %)[b]	-83,33	-41,67	-83,34	-83,34
Corporate Income Tax (25 %)	-104,17	10,42	-104,17	-104,17
Solidarity Surcharge (5,5 %)	-5,73	0,57	-5,73	-5,73
Distributable Profit	306,77	-30,68	306,77	306,77
Level of Parent Company in GER				
Capital Income (Art 49 (1) 5a German ITA)	306,77	0,00	306,77	306,77
No Withholding Tax on Dividends (Art 43b German ITA)	0,00		0,00	0,00
No Withholding Tax on Interest (Art 43 (1) 7 German ITA)		0,00		
Level of Parent Company in AUT				
Participation Exemption	306,77		306,77	
Interest Income		500,00		500,00
Corporate Income Tax (25 %)		-125,00		-125,00
Net Profit	**306,77**	**344,32**	**306,77**	**181,77**
Total Tax Burden	**193,23**	**155,68**	**193,23**	**318,23**
	38.65%	**31.14%**	**38.65%**	**63.65%**

[a] Interest payment > 250.000 €, > safe haven but positive arm's length test
[b] Half of the interest on long-term debt has to be added for trade tax purposes
[c] Interest payment > 250.000 €; > safe haven, negative arm's length test

Table 9 *Tax Consequences of Cross-Border Shareholder Loans in Comparison*

Table 9 clearly shows that a shareholder loan (31.14 %) is more favourable than an equity investment as long as the safe haven of 251.000 € is not exceeded or the arm's length test was positive. If the unobjectionable debt to equity ratio is exceeded, however, the minimum tax burden amounts to 38.65 % and equals the tax burden of a regular equity contribution. A tax burden of 63.65 % has to be expected if the country of residence, namely Austria, is not willing to make a corresponding adjustment. Economic double taxation is the result. In order to avoid the worst case tax burden, the parent company may substitute half of the shareholder loan by a hybrid financial instrument. Depending on the classification of the hybrid instrument as either equity or debt the safe haven of Art 8a German CTA will be exceeded or not.

Source Country: Germany **Country of Residence: Austria**			
	Shareholder Loan + Hybrid Instrument		
Method of Finance	GER: HI = Equity → no Art 8a AUT: Interest/Dividend[a]	GER: HI = Debt → Art 8a AUT: Interest/Interest[c]	GER: HI = Debt → Art 8a AUT: Dividend/Dividend[d]
Level of Subsidiary in GER			
EBIT	500,00	500,00	500,00
Interest on Loan	-250,00	-250,00	-250,00
Interest on Hybrid Instrument		-250,00	-250,00
+ Reclassified Interest (on Shareholder Loan)		250,00	250,00
+ Reclassified Interest (on Hybrid Instrument)		250,00	250,00
EBT	250,00	500,00	500,00
German Trade Tax (16,67 %)[b]	-62,50	-83,34	-83,34
Corporate Income Tax (25 %)	-46,87	-104,17	-104,17
Solidarity Surcharge (5,5 %)	-2,58	-5,73	-5,73
Distributable Profit	138,05	306,77	306,77
Level of Parent Company in GER			
Capital Income (Art 49 (1) 5a German ITA)	138,05	306,77	306,77
No Withholding Tax on Dividends (Art 43b German ITA)	0,00	0,00	0,00
No Withholding Tax on Interest (Art 43 (1) 7 German ITA)	0,00		
Level of Parent Company in AUT			
Participation Exemption	138,05		306,77
Interest Income (Loan and Hybrid Instrument)	250,00	500,00	
Corporate Income Tax (25 %)	-62,50	-125,00	
Net profit	**325,55**	**181,77**	**306,77**
Total tax burden	**174,45**	**318,23**	**193,23**
	34.89%	**63.65%**	**38.65%**

HI Hybrid Instrument
[a] Austria classifies the return on the shareholder loan as interest and the return on the hybrid instrument as dividend
[b] Half of the interest on long-term debt has to be added for trade tax purposes
[c] Austria classifies the return on the shareholder loan as interest and the return on the hybrid instrument as interest (no corresponding adjustment)
[d] Austria classifies the return on the shareholder loan as dividend and the return on the hybrid instrument as dividend (corresponding adjustment)

Table 10 *Tax Consequences of Hybrid Instruments in Thin Capitalization Situations*

Through the use of an equity-alike hybrid instrument in connection with a (lower) shareholder loan the tax burden can be reduced to 34.89 %. Compared to the tax burden of a pure loan financing (table 9) this structure is a bit less favourable; the risk of a reclassification according to the thin capitalization rule, however, is eliminated. Compared to the tax burden of pure equity finance (table 9) the substitution by an equity-alike hybrid instrument is more favourable not only with regard to the tax burden but also with regard to the legal requirements. The use of debt-alike hybrid instruments, on the other hand, leads to a tax burden of 38.65 % provided Austria makes a corresponding adjustment. If the country of residence of the parent company refuses to make a corresponding adjustment, as in most cases, again double taxation is the result.

V. CONCLUSION

Hybrid financial instruments clearly offer tax planning opportunities, in particular in a cross-border setting. Hybrid instruments may be tailored in a way that they provide capital that is economically similar to equity but taxed as debt. With regard to the variation in the extent to which such instruments are used and the inconsistency in tax classification between countries the overall corporate tax burden can be minimized. However, the use of hybrid financial instruments can be risky. In connection with thin capitalization the favourable tax consequences of debt-alike hybrid financial instruments may reverse:

- The deductibility of payments on excessive ‘debt’ at the level of the subsidiary is lost,
- Double taxation may arise when the residence country is not willing to make a corresponding adjustment;
- Other group financing structures may be influenced negatively.

Therefore the use of equity-alike hybrid instruments becomes more advantageous. The main question, which classic method of finance – debt or equity - hybrid instruments are assigned to in thin capitalization rules has to be answered for each country separately. These findings are, however, not valid for countries:

- which do not sanction thin capitalization at all
- which do sanction thin capitalization only in very extreme cases and
- whose thin capitalization rules do not include hybrid financial instruments at all.

In planning business with companies situated in these countries the traditional tax policy will be effective. The present paper is of particular importance to the field of tax management as it calls attention to find alternatives in cross-border company finance. Leasing contracts, factoring, real capital investments or (non-revolving) short-term loan financing are only a few examples (e.g. Obser, 2005: 159 et seq.).

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[i] It should be noted that in an international context the level of corporate tax is decisive also. As to minimize the group tax rate, parent companies situated in a high tax country will decide to finance their foreign subsidiary with equity rather than debt.

[ii] The most important capital import and capital export countries were chosen according to the income of direct foreign investments and the income of foreign direct investments in Austria. See *Österreichische Nationalbank*, Österreichische Direktinvestitionen im Ausland und ausländische Direktinvestitionen in Österreich, Stand per Ende 2005, Sonderheft Statistiken, 26 f,

http://www.oenb.at/de/stat_melders/statistische_publika/aussenwirtschaft/direktinvestitionen/di_berichte_20051028_direktinvestitionen_2003.jsp#tcm:14-37319 (14.6.2006).

[iii] In this context literature often mentions the unwritten 'principle of the freedom of finance' or the 'principle of the free management of enterprises' that can be derived from jurisdiction (e.g., Obser, 2005: 1).

[iv] See also Kahn and Lehman, 2001: 56 et seq. and McDaniel and McMahon and Simmons, 1999: 499 et seq., 507.

[v] The word 'mezzanine' can be derived from the Italian word 'mezzanino' used in architecture. The term 'mezzanine finance' is typically used in business context, especially in connection with Leveraged Buy-Outs. From a tax perspective the term 'hybrid finance' is more common.

[vi] Especially the decision of the European Court of Justice in the case *Lankhorst-Hohorst* caused the broadening of the scope of several thin capitalization rules. In the case *Lankhorst Hohorst* the European Court of Justice decided that the German thin capitalization rule applied to non-residents only is incompatible with the right of establishment. See ECJ, 12 December 2002, C-324/00, *Lankhorst-Hohorst* [2002] ECR I-11802.

[vii] For a clear definition of the term 'back-to-back-loan' see e.g., Piltz, 1996: 107.

[viii] Shareholder loans are sometimes referred to as hybrid (financial) instruments because owners take the position of a creditor.

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