The Taxation of Hybrid Financial Arrangements

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INTRODUCTION

Hybrid instruments — used as early as the 16th century by the first English companies — have increased in complexity over recent decades following the explosion in derivatives and developments in financial engineering. Some of the better known hybrid instruments include certain classes of preference shares, convertible notes, capital protected equity loans, profit participating loans, perpetual debt, endowment warrants, equity swaps and so on. Hybrid instruments continue to be developed because both issuers and holders have perceptions (albeit largely based on different expectations) that these instruments embody certain yield, cost, risk, insurance, taxation, hedging, control, gearing, cash flow, convertibility, diversification and optionality advantages relative to traditional instruments. Information asymmetry between managers within corporate structures on the one hand and outside investors on the other, and domestic/foreign tax asymmetries, are also influential.

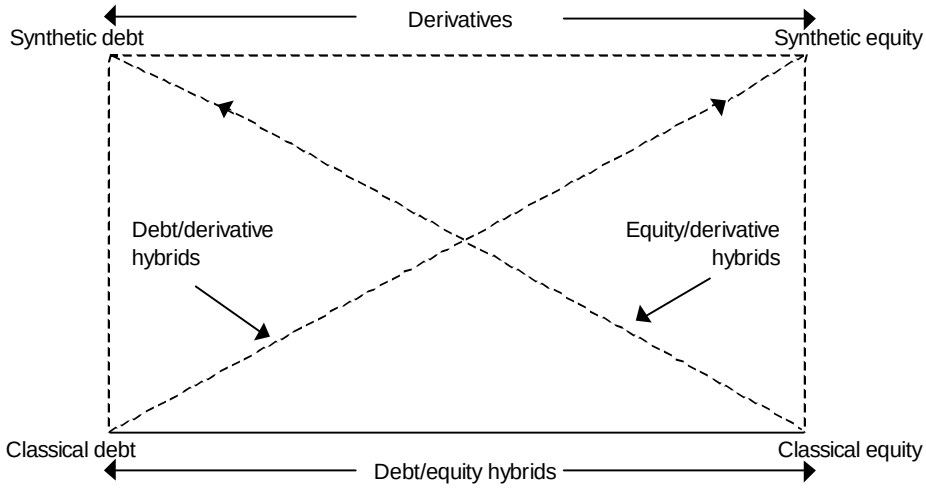
Hybrid instruments are not only used to achieve investment, financing and risk management objectives but they can also be deployed to outflank and confound the traditional tax distinctions between debt (generally accruals and deductible) and equity (realisation and generally frankable). For example, depending on tax status and circumstances, there may be advantages to be gained by issuing or holding hybrid instruments to selectively characterise returns as dividends or as interest, including the structuring of a debt-like instrument to yield frankable returns or an equity-like instrument to yield interest returns. As taxpayers attempt to select and arbitrage among the different debt and equity tax treatments using modern hybrid instruments, tax benefits may be misdirected, innovative activity dissipated and government revenues threatened. Blunt, asymmetric, anti-avoidance rules sometimes become necessary and these have the potential to impact adversely on non-tax-driven hybrid transactions.

Some commentators have pointed to adverse impacts of current hybrid taxation arrangements on taxpayer uncertainty, access to particular savings and risk

management vehicles, the structure of relative prices and financing and investment patterns, and competitiveness. Others have concluded that, because of modern financial innovation, the traditional taxation distinctions between debt and equity and between 'fixed' and 'contingent' returns are now so problematical that it is impossible to achieve widespread consistency of tax treatments across hybrids and other financial arrangements. The policy challenges posed for the income-based business tax system by these seemingly intractable considerations are far reaching and complex.

Figure 1 provides a frame of reference. It is assumed that the general policy objective is to secure the greatest possible consistency in tax treatments among the instruments falling within the bounds of Figure 1.

Figure 1: Debt, equity, hybrids and synthetics



In what follows four methods of taxing hybrid instruments are examined on the assumption that the current tax treatments of debt and equity remain unaltered. The first three methods involve a sharp discontinuity at the debt/equity borderline. The fourth works to remove the sharpness of that discontinuity for hybrid instruments, and to secure greater consistency in tax treatments across all financial arrangements, by means of 'dual bifurcation'.

A) Method 1: The debt and equity characteristics approach

The current law generally approaches the tax treatment of hybrid transactions from the perspective of legal-form, with limited exceptions to take economic substance into account. This approach has generated taxpayer uncertainty, tax arbitrage and avoidance, inequity, and administrative and policy complexity. In Australia's case punitive anti-avoidance provisions (section 46D and 82R of the Income Tax Assessment Act) impact adversely on some hybrid instruments by

denying both deductibility and frankability for certain returns which would otherwise be either deductible or frankable.

The traditional *'debt and equity characteristics approach'* (or 'reasoning by analogy' approach as it is sometimes called) has major limitations, but it is, nonetheless, widely regarded as a concomitant feature of a differentiated tax system. This approach usually involves an attempt to categorise instruments according to whether they have more 'debt' features or more 'equity' features relative to benchmark characteristics. Usually an attempt is made to locate the debt/equity borderline toward the center of the debt/equity spectrum (on the lower horizontal axis in Figure 1). 'Blanket' tax treatment is then applied: if the judgement is that the 'debt' features dominate then the whole instrument is accorded debt treatment, and vice-versa for the case of the assignment of equity treatment. Most often a 'facts and circumstances test' is adopted based on listings or definitions of either debt or equity characteristics. Under the *debt and equity characteristics approach* the aim of the tax authority is to classify hybrids by the 'debt/equity-cubbyhole' system already embedded in business tax systems.

The 'blanket' application of traditional, cubbyhole treatments is antiquated and inadequate in the face of modern financial innovation. Quite apart from other considerations, that approach is not sufficiently specific, robust nor flexible enough to properly account for the different investment, financing and risk management functions that can be performed by identical financial arrangements, or for the fact that different instruments can be used to achieve the same risk management and financing tasks. Experimentation with the *debt and equity characteristics approach* in the United States and Canada has not been encouraging.

As the separate 'facts' and the individual 'circumstances' relating to a particular hybrid instrument may be interrelated and interdependent in terms of their application and significance, no simple weighting procedure seems practicable as a method to determine 'debt' or 'equity'. As the number, and variants, of hybrid instruments increase, a labyrinth of rulings, guidelines and rules-of-thumb ultimately becomes necessary, and even then some subjectivity remains. Partly for such reasons a 'facts and circumstances' test generally results in considerable uncertainty in relation to the classification of hybrid instruments which are closest to the debt/equity border (as defined by the tax authority). Issuers and holders of hybrid instruments may hold different views as to whether the instrument is predominantly debt or equity. The tax authority may need to make case-by-case rulings for such instruments and in some cases, court decisions, which themselves may be controversial, become necessary. As the underlying hybrid instruments become more complicated the application of the 'facts and circumstances' approach can become increasingly difficult. That said, tax authorities have been drawn to that approach as it provides a mechanism to deal effectively with tax arbitrage.

Attempts to apply legal form-based debt and equity treatments to contingent and non-contingent cash flows / returns are not self-executing (that is to say, the 'cubbyhole' approach cannot automatically determine whether instruments which incorporate different contingent cash flows should be taxed as debt or as equity). For hybrids, this results in taxpayer and investor uncertainty and, of course, involves a substantial discontinuity at the debt / equity borderline. That debt / equity discontinuity ensures that for a very minor change in the terms / conditions / characteristics attaching to some hybrid financial arrangements there can be, relatively speaking, a very large change in tax treatment of the whole instrument. That change in the tax treatment is far out of proportion to the change in the financial character of the instrument. Furthermore, the administrative cost of policing and shoring up the debt / equity borderline is very substantial. The non-self-executing nature of the approach can itself create potential for anomalies in tax treatments. In the absence of international harmonisation of 'debt' and 'equity' definitions, cross-border tax arbitrage opportunities are opened-up and are difficult to address.

For the *debt and equity characteristics approach* to be pertinent in the face of financial innovation it would be necessary to refocus the list of relevant 'facts and circumstances' used to determine debt and equity categorisation to provide a greater role for economic substance over legal form.

B) Method 2: A single determinative factor

Sharper definitions of debt and interest, and possibly equity and dividends too, could perhaps facilitate the effectiveness of the 'facts and circumstances' approach. Such definitions may, perhaps, best be centred on the single proposition that in respect of hybrid instruments the existence of a debtor / creditor relationship is determinative of debt. Thus, under the *single determinative factor approach*, debt could be defined as the 'right' to receive at least the principal back and consequently the existence of certain 'creditor' rights in contracts or prospectuses would determine whether debt treatment is to apply to hybrid instruments. Alternatively, a company / shareholder relationship may be used to identify 'equity' and could possibly be defined, at least for convertible instruments and listed entities, in terms of economic or financial parameters (such as, for instance, the correlation between the hybrid's price and the price of the issuer's ordinary shares, that is the 'delta').

Under this simpler approach uncertainty may be lowered but the sharp discontinuity remains.

C) Method 3: Tax hybrids as equity or tax hybrids as debt

Another way to remove some of the uncertainties inherent in the above-described *debt and equity characteristics approach* (Method 1) is to move the debt / equity borderline as close as is possible to the debt end of the debt / equity

spectrum (ie to the left-hand end of the lower horizontal axis in Figure 1) and to construct a very clear and precise definition of debt. Alternatively one could move the borderline to the equity end of the debt/equity spectrum (ie to the right-hand end of the lower horizontal axis in Figure 1) and proceed to concisely define 'equity'.

As with Method 2, Method 3 represents an advance over Method 1 in that uncertainty is lowered somewhat and complexity reduced. In addition, where a hybrid is taxed as equity there would arguably be less scope for the taxpayer being rewarded by the tax system for simply, but skillfully, fine-tuning and disguising the terms and conditions of an instrument in order, say, to obtain debt treatment (ie deductibility) in respect of instruments that include equity elements (and which may even be recorded as equity in the commercial accounts and by rating agencies). However, Method 3 still retains the disadvantage of retaining the sharp discontinuity, either at the point which separates debt from hybrids (and equity) or at the point separating equity from hybrids (and debt). Because of this discontinuity, and the 'blanket' application of either 'debt' or 'equity' tax treatment, Method 3 cannot deliver tax outcomes for hybrid instruments which are fully consistent with their underlying financial economics.

Furthermore, some taxpayers may view one of the possible treatments under Method 3 — where hybrids are taxed as equity — as somewhat rough and ready and unduly favourable to the revenue. The alternative approach under Method 3 — taxing hybrids as debt — could have substantial revenue implications.

D) Method 4: The dual bifurcation approach

Another possible methodology to deal with the debt/equity interface could involve the bifurcation of the cash flows/returns attaching to hybrid instruments. In the relevant literature the following formulation is generally used as a definition, viz: '…under bifurcation the tax treatment of a position is equal to the sum of the tax treatments for the underlying units'.

As discussed in the literature, and applied in practice, it is seemingly assumed that a single bifurcation can be used to determine the tax treatment of hybrid instruments. This may be questionable given the potential range of different cash flows and tax attributes which attach to any financial instrument: the weight placed on that single policy determinant (ie the single bifurcation) seems excessive. In contrast, the approach developed in this paper involves the application of two separate bifurcations. Thus hybrid instruments are decomposed into four dimensions as illustrated below:

Bifurcation A): The anticipatable/accruals–cum-unanticipatable/realisation bifurcation.

This bifurcation involves splitting the cash flow / returns according to whether they are 'anticipatable' or 'unanticipatable'. Anticipatable cash flows / returns are **accrued** while unanticipatable cash flows / returns are taxed on **realisation**.

Bifurcation B): The interest/deductibility-cum-dividend/frankability bifurcation.

This bifurcation involves splitting the periodic costs on the basis of whether they are 'interest' (debt-related) or 'dividends' (equity-related). Interest costs are generally **deductible** while dividends are generally **frankable**.

The *dual bifurcation approach* provides the potential to remove the sharp discontinuity (which disrupts the horizontal debt / equity axis in Figure 1) inherent in Methods 1, 2 and 3.

TWO SEPARATE BIFURCATIONS

Bifurcation A) in greater detail

Bifurcation A) provides a mechanism to resolve **tax-timing treatments**. Under Bifurcation A) anticipatable cash flows / returns would be taxed on an **accruals** basis and unanticipatable cash flows / returns would be taxed on a **realisation** basis. The separation achieved under Bifurcation A) cannot be avoided in a mixed accruals / realisation–based tax system (the border between 'accruals' and 'realisation' must be defined). The approach to accruals in Bifurcation A) appears to be generally consistent with the *expected value taxation system* which has been proposed by Reed Shuldiner (*Texas Law Review*, Vol 71, December 1992) as a general basis for taxing financial arrangements.

The precise specification of what constitutes an 'anticipatable' and what constitutes an 'unanticipatable' cash flow / return would necessarily involve policy decisions and the development of relevant definitions and, possibly, rules for particular instruments. However, for the vast majority of basic instruments (debt, equity, hybrids, options, futures and swaps) the definitions / rules would be relatively straightforward. The objective of these rules would be to split out the separable anticipatable and unanticipatable cash flows / returns.

'Anticipatable' cash flow / returns would certainly include those cash flows / returns that are fully and unconditionally anticipatable (ie future cash flow / returns that are known with complete certainty). An 'anticipatable' cash flow / return might possibly also include those that are classified as 'fixed' or can be estimated / projected with a high degree of certainty (ie a high probability of the payment occurring at a future time as specified when the contract is entered). However, a cash flow / return would not be classified as an 'anticipatable' cash flow / return merely because a taxpayer believed he or she could speculate as to the instrument's likely future value.

An example of an anticipatable cash flow / return arising in relation to a debt instrument would be a fixed rate periodic return. For most variable return debt instruments the interest rate for the relevant tax period may also be known or may be estimable (say, by using forward rates). Most plain vanilla swap payments may be anticipatable and accrued. Depending on the policy rules settled on, certain special 'fixed' or 'preference' dividends (particularly those paid by highly rated companies) may provide an example of an equity-related periodic cash flow / return that would, when viewed at the time of issuance, usually have a relatively high probability of taking place. Such a return could, therefore, be 'anticipatable' and conceivably 'accrued'.

Examples of an unanticipatable cash flow / return would include payments that may not be known in advance, or the change in the capital value of debt instruments resulting from the general movement in interest rates. The relevant 'principal' cash flow attaching to a 'contingent principal' debt instrument would be unanticipatable. Normal dividends are highly uncertain payments and would be treated as an unanticipatable cash flow / return. The capital gain or loss on the disposal of an equity would be unanticipatable. The settlement payments on forwards and options and the gains and losses from future currency movements are all highly uncertain and would, therefore, be treated as unanticipatable, and taxed at realisation.

The application of the *anticipatable/accrual-cum-unanticipatable/realisation* treatment provides one part of a (two-part) methodology aimed at removing the sharp **debt/equity** discontinuity which would exist under Methods 1 or 2 or the **debt/hybrid** or **equity/hybrid** discontinuity which would exist under Method 3.

Under the *anticipatable/accrual-cum-unanticipatable/realisation* rule one part of the tax treatment (ie the tax-timing treatment) of any financial hybrid is a function, in the first instance, not of a 'blanket', legal form-based tax treatment, but of the expected degree of certainty of payment of the cash flows / returns associated with the instrument. Consequently, under this approach, the blend of tax-timing treatments relevant for a given hybrid instrument never changes sharply as the character of the instrument changes; rather, the tax treatment changes gradually, in line with (proportionately to) gradual changes in the nature / character of hybrid instruments. Thus, as the second module of Figure 2 illustrates, when moving from the classical equity end of the debt / equity spectrum toward the classical debt end, as a greater part of the cash flows / returns becomes predictable / certain overall the effective tax treatment of hybrid instruments becomes more 'accruals-oriented'. When moving in the opposite direction (toward the equity end), as a greater part of the cash flows / returns becomes unpredictable / less certain the effective tax treatment of hybrid instruments becomes more 'realisation-oriented'.

Taking the extreme points along the base horizontal axis in Figure 1, at one end all classical equity cash flows / returns are unanticipatable while at the other end all classical debt flows (assuming no market fluctuations) are anticipatable.

Conveniently, the proposed 'anticipatable / unanticipatable' tax-timing dichotomy fits well with the current basic tax treatments of classical debt and classical equity.

Bifurcation B) in greater detail

A second bifurcation is used to determine the nature of the **tax attributes** (**deductibility or frankability**) to be applied to the periodic costs (ie interest or dividend payments) of issuing the instrument. Bifurcations of the periodic payments attaching to debt and equity instruments must necessarily be based on rules which could specify those types of payments that would constitute 'interest' (debt-type) and those payments that would constitute 'dividends' (equity-type). Such rules / definitions would need to be consistent with, and linkable to, the operation of the dividend imputation system so that 'dividends' could be franked by the issuer and provide the basis of determining the application of 'rebatability' to relevant cash flows / returns flowing to holders of equity instruments.

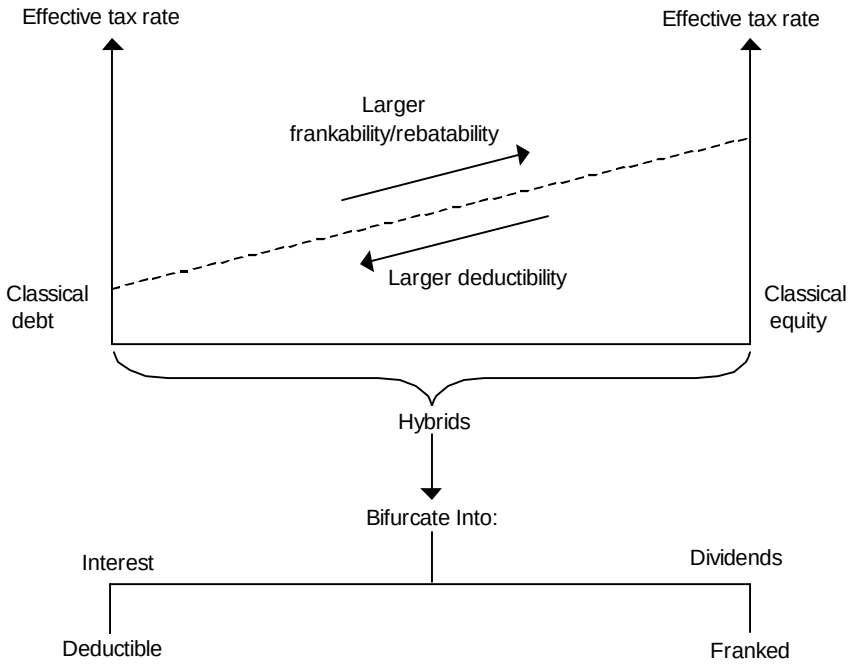
Rules of this type are a necessary feature of any approach which attempts to resolve the conundrums posed by the perpetuation of the current debt / equity distinction. Ideally these rules would result in a categorisation of periodic payments as dividends or interest according to their economic substance. As a result, the misdirection of tax benefits arising from, say, hybrids which are shares in legal form but debt in economic substance (for example, redeemable preference shares paying 'dividends' which are equivalent to interest on a loan) would be avoided by treating the returns for tax purposes as their economic equivalent (namely, interest). The issue of such debt-like shares by companies in tax loss in order to convert an unusable tax deduction of the company into a tax rebate in the hands of the 'shareholder' led to the introduction in 1987 of Section 46D of the *Income Tax Assessment Act 1936*, a provision which would no longer be required if periodic payments are correctly categorised as dividends or interest according to their economic substance. It is conceivable that a definition of 'dividends' only would be necessary (so that all other periodic payments would be treated as interest).

As with the first bifurcation, the tax treatment applying to hybrid instruments under the second bifurcation — Bifurcation B — changes gradually. As the top module of Figure 2 illustrates, as the hybrid instrument incorporates more 'debt' relative to 'equity' (ie moving right to left) the greater is the incidence of deductibility. If, for example, a convertible hybrid instrument has a relatively greater equity element (determined, say, by a discounted cash flow valuation procedure or financial measure such as 'delta') then the incidence of frankability is proportionately greater. In this characterisation it is assumed that the issuers of such instruments can evaluate separate cash flow / returns in terms of whether they are 'interest' or 'dividends', based on clear definitions that would be provided in legislation. It is also possible that if there are cases where unique

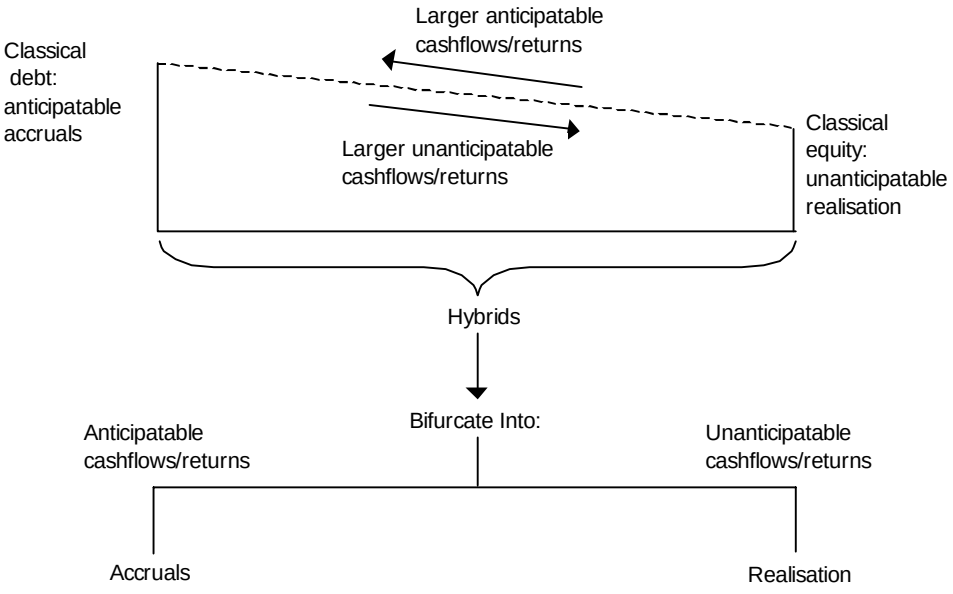
bifurcations are not feasible (for Bifurcation B) additional bifurcation rules may be needed to determine relevant valuation methods to be used for tax purposes.

Figure 2: Dual bifurcation applied to debt/equity hybrids

Deductible/frankable treatment



Accruals/realisation treatment



While dynamic bifurcation procedures may be technically feasible (where the debt / equity character of a hybrid instrument changes through time) recharacterisation on an annual basis under the second bifurcation may impose complexity and add uncertainty to investor choices. Bifurcation valuations at the inception of the hybrid arrangement, rather than on a dynamic periodical basis during the life of the instrument, may be judged the more practicable approach.

THE SYNTHESIS OF TWO BIFURCATIONS

The intersection between the tax treatments of hybrids and other financial arrangements with the rest of the business tax system is a critical junction. The separation of the 'accruals / realisation' tax-timing treatment determination from the 'deductibility / frankability' attribute determination represents the essential analytical advance inherent in the dual bifurcation approach. In Australia's case such a separation could potentially allow a relatively straightforward linkage of any hybrid's tax treatment to:

(A) *the taxation system applying to 'other' financial instruments* (assuming that the anticipatable / unanticipatable dichotomy could be adopted as the basis to tax other financial arrangements); and

(B) *the dividend imputation system*.

Thus, where a dividend imputation system is in place, the application of the dual bifurcation principle to hybrids could possibly translate into the general working principles illustrated in Table 1.

It is arguable that dual bifurcation (ie the combination of the anticipatable / accrual–cum-unanticipatable / realisation rule and the interest / deductibility-cum-dividend / frankability rule) provides a consistent application of the basic differences between the existing tax treatments of debt and equity along the spectrum of hybrid instruments which runs between purest (classic) debt and fully contingent equity. Compared to current tax treatments, hybrid instruments could be taxed with greater consistency under this approach and a greater incidence of (tax) uniqueness would be achievable. Importantly, the synthesis of the dual tax treatments applied to hybrid instruments under this approach would be inclusive only of the tax treatments already applying to classical debt and classical equity.

Table 1: The taxation treatments of hybrids under dual bifurcation

For periodic payments:	
Anticipatable (interest) cash flow/returns	
	holder = accrual
	issuer = deductibility, accrual
Unanticipatable (interest) cash flow/returns	
	holder = realisation
	issuer = deductibility, realisation
Anticipatable (dividend) cash flows/returns	
	holder = accrual, rebatable
	issuer = franked, accrual
Unanticipatable (dividend) cash flow/returns	
	holder = realisation, rebatable
	issuer = franked, realisation
For non-periodic payments (ie capital amounts):	
The unsystematic (unanticipatable) gain or loss attaching to the capital amount (either the principal for debt or the issue price for equity) would be taxed by the base price adjustment at the point of realisation.	

Arguably, in comparison to Methods 1, 2 and 3, the '*dual sliding scales*' (synchromesh-type) tax treatment (Method 4) provides a more meaningful and less distorted reflection of the financial economics of the instruments concerned (within the constraints imposed by the existing tax treatments of classical debt and classical equity). The sharp discontinuity (a feature of Methods 1, 2 and 3) is removed and the hybrid instrument is not subjected to a 'blanket' tax treatment based on an assessment of selected facts and circumstances. Rather, the components are taxed separately and the tax-timing treatment and tax attributes are separately assigned in order to better reflect economic substance. In this way the dual bifurcation approach delivers a greater degree of tax 'continuity' (such that, as the American literature explains, portfolios that are nearly identical would have nearly identical tax outcomes). Assuming that the rules defining an 'anticipated' cash flow/return and a 'deductible' return are sufficiently clear and succinct, the uncertainty traditionally surrounding the taxation of hybrid instruments should be substantially reduced. As well, barriers to the mature development of dynamically complete markets along the debt/equity spectrum — including certain current tax barriers in Australia's case — should also be favorably impacted, resulting in lower financing costs and improved risk management.

The dual bifurcation approach overcomes one of the main deficiencies of approaches based on a single bifurcation. With a single bifurcation it is not possible to automatically deal with all combinations of contingent and non-contingent returns and (by applying one policy instrument in order to address two objectives) it alone cannot simultaneously resolve both the tax-timing treatment (accruals or realisation) and the determination of tax attributes (deductibility or franking). In contrast, the dual bifurcation approach separates the two objectives and involves the separate assignment of two policy instruments (ie two different bifurcations), one to each objective. Assuming clear

definitions and rules can be developed, dual bifurcation holds out the prospect of being largely self-executing and, thereby, breaks through a critical constraint. It is likely, therefore, that the adoption of the dual bifurcation approach would reduce uncertainty in respect of the taxation of the more complex hybrid instruments.

If a scheme of this type (Method 4) were to be adopted the scope for undesirable tax arbitrage across the debt/equity borderline would appear to be substantially constrained. This is so because the dual bifurcation rules discussed here have the advantage of substantially widening the border separating debt from equity: the advantage of this 'corridor' is to ensure that the transaction cost and additional risks involved in 'jumping' from all-debt to all-equity treatment, or vice versa, would tend to outweigh any beneficial tax effect of so doing. In this way the adoption of a dual bifurcation approach for hybrids makes the otherwise existing debt/equity discontinuity less sharp and less subject to tax-based manipulation. Thus, innovative tax arbitrage would tend to become less attractive while opportunity would still exist for issuers to fine-tune the financial/economic attributes of particular hybrid arrangements to suit their non-tax purposes. Holders could select among a wider range of arrangements incorporating greater potential diversity of financial/risk characteristics and effective taxation treatments. The tax system, therefore, would be better focussed and would be working to provide greater certainty and enhanced 'market completion', thereby facilitating efficient and non-distorted capital markets.

Because the tax treatments of the bifurcated parts of the debt/equity hybrid instrument would generally be the same as (and add up to) the tax treatment of the whole hybrid instrument, a system for taxing debt/equity hybrids of the type described in this paper would appear to posses a greater weighting of desirable 'linearity' properties than some other approaches. As well, because both bifurcations operate within the boundaries of the existing tax treatments of debt and equity, no malignant asymmetries in tax treatments (say, as between issuer and holder) are involved.

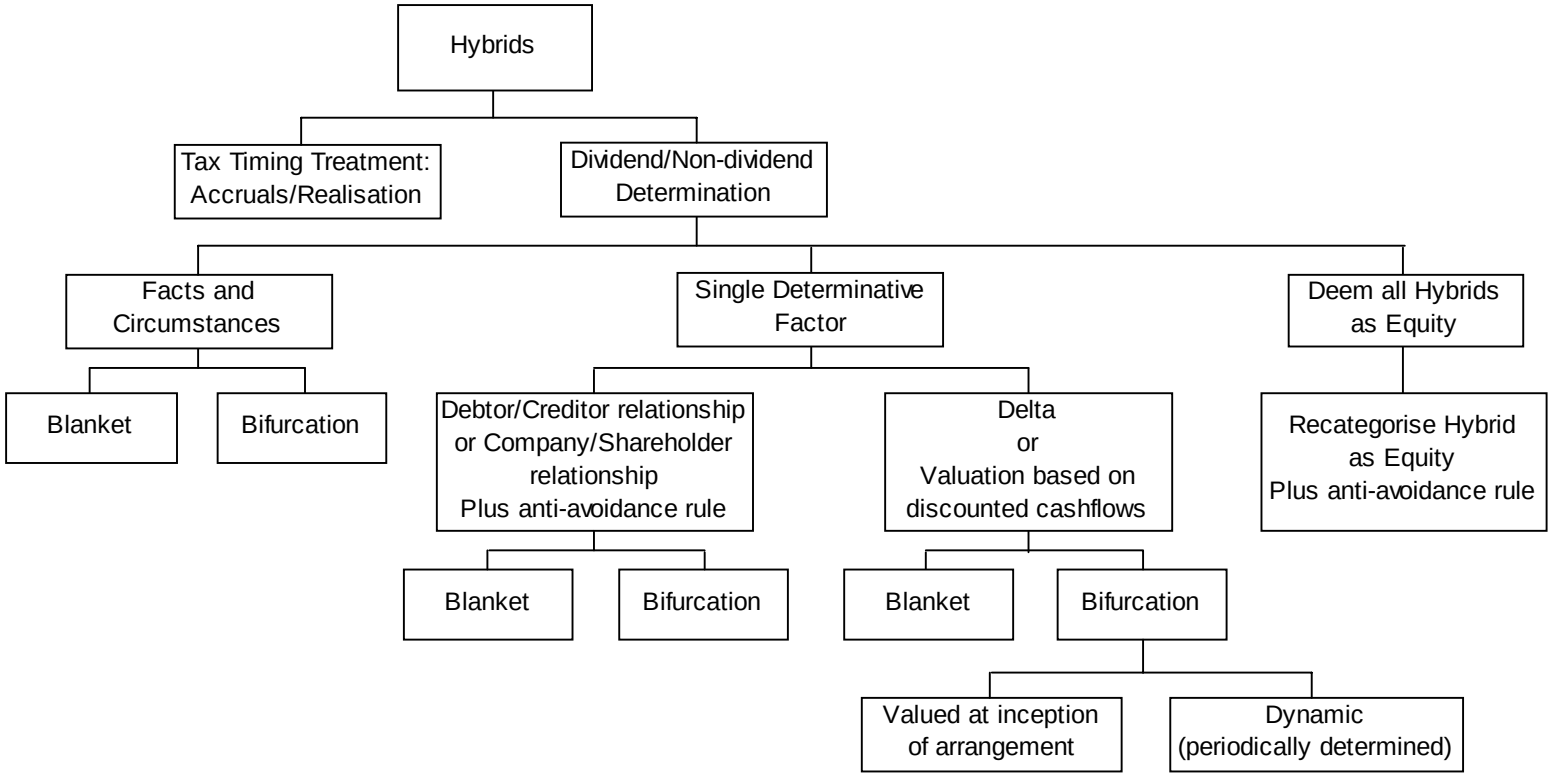
An additional virtue of Method 4 is that the first (tax-timing) bifurcation (based on 'anticipatable ' and 'unanticipatable' cash flow/returns) can be applied to derivatives (which fall along the upper horizontal axis in Figure 1). As a consequence, Method 4 also provides a means of achieving consistent tax treatments between debt/equity hybrid instruments (which fall along the lower horizontal axis in Figure 1) and that wider class of hybrids which combine securities with derivatives (and which fall along the cross-diagonal intervals in Figure 1). Arguably, therefore, as the accruals and realisation approaches can be applied to debt, equity, foreign currency, derivatives and hybrids, the dual bifurcation approach could provide scope for much greater overall uniformity and consistency in tax treatments across financial arrangements than that which currently exists.

Finally, some hybrids have financial parameters which remain fixed over their full term. However some hybrid transactions (convertible notes and shares) have dynamic parameters embedded in their structure which change over the term of the instrument. For instance, due to an embedded option, the risk profile of a converting preference share may change over time (toward that of equity if the ordinary share price rises) as the instrument moves towards maturity. This 'converting' class of hybrids may (depending on parameters, such as whether or not conversion is mandatory) require the development of additional taxation rules (including, perhaps, rules based on changes in the relevant 'delta') to reflect the dynamic change over time in the financial economics of the instrument. Where a convertible instrument is so 'deep-in-the-money' that it is certain to be converted it could possibly be taxed from the outset assuming that conversion had taken place (this would require a clear definition of what constitutes very 'deep-in-the-money').

It is the case, of course, that some taxpayers may seek to play across the 'anticipated / unanticipated' border in order to gain from adverse selection. This could mean that certain taxpayers may seek to achieve 'realisation' treatment for certain cash flows instead of 'accruals' treatment, and vice versa. The ability of taxpayers to do this would depend in part on the accruals methods adopted in the tax law and the specification of the 'default' treatment. For example, annual rebalancing and resetting may provide less scope for adverse selection than some other accruals methods, and the scope for tax 'deferral' could be reduced further if 'accruals', rather than 'realisation', was legislated as the basis for the default treatment.

That said, there are two natural safeguards against adverse selection in this area. First unanticipatable cash flows have greater uncertainty attaching to their future evolution, and they are, therefore, relatively risky. However, given the existence of other (arguably more powerful) influences on risk-taking (including the passage of time and unforeseeable events) and the fact that issuers are generally risk averse, the danger to the revenue from this source may not be overwhelming. This is particularly so as we currently live with a (largely) realisation-based system. Second, such manipulation as might occur between 'anticipated ' and 'unanticipated' cash flows would not bear on whether the cash flows concerned are deductible or frankable, or classified as deriving from 'debt' or 'equity'. Thus, the extent of any manipulation across the 'anticipated / unanticipated' border under the dual bifurcation approach is likely to be much less substantial in its impact than manipulation across the debt / equity border under the blanket 'facts and circumstances' approach. Nonetheless, in respect of the anticipated / unanticipated distinction, there may need to be an emphasis placed on relevant anti-avoidance rules. To the extent the debt and equity elements are separated concisely by the second bifurcation the need for other anti-avoidance rules would be reduced or eliminated.

Figure 3: Hybrid tax treatments



CONCLUDING COMMENTS

Of the four methods for taxing hybrid instruments discussed above, the dual bifurcation method has the greatest novelty. Subject to their practical feasibility, the two bifurcations provide the analytical potential for a delicate, but relatively straightforward, dual docking operation.

The first bifurcation (based on the anticipatable/unanticipatable dichotomy) would permit the coupling of tax-timing treatments applying to hybrid financial instruments with the same tax-timing treatments which could conceivably be applied to other financial arrangements (debt, equity, derivatives and foreign currency) and to assets more generally. On this basis all 'anticipatable' cash flows/returns could be accrued irrespective of the 'legal form' of the financial arrangement. This first bifurcation works in a manner that is non-distorting to the key pricing parities and equivalences which are established primarily by market-makers who would desirably be taxed on a mark-to-market basis (to avoid tax-timing mismatches between 'long' and 'short' positions).

The second bifurcation provides a potential mechanism to achieve a robust connection between the tax attributes treatment applying to equity-related hybrid financial instruments and the dividend imputation system, while at the same time facilitating, but leaving undisturbed, the tax attribute treatment applying to debt instruments.

The net result of both bifurcations is to work toward reducing the dependency of the income tax system on the distinction between 'fixed' and 'contingent' returns. At the same time the approach provides a theoretical basis for achieving greater continuity, enhanced consistency and minimal interference with legitimate transactions and financial innovation, by seeking to apply equivalent tax treatments to financially equivalent hybrid instruments.

The dual bifurcation approach offers an analytical paradigm which opens up a richer menu of policy instruments for taxing hybrid arrangements. Figure 3 provides an illustration of how that richer menu might be presented. The ultimate selection among the different policy options on the menu involves a weighing up of the different advantages and disadvantages of each viewed against objectives such as certainty, simplicity, consistency and continuity, and the practicability of relevant valuation methodologies.