HYBRID SECURITIES AND THE DEBT–EQUITY CLASSIFICATION PROBLEM*

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ABSTRACT

The debt–equity classification problem appears at first glance to be a simple matter until one deals with: (i) hybrid securities with characteristics of both debt and equity, and (ii) aggressive financial engineering and tax planning techniques that exploit the differential regulatory treatment between debt and equity instruments, an activity called "regulatory arbitrage". This paper provides a systematic method of dealing with the debt–equity classification problem, with focus on corporate taxation. In achieving this, this paper: (i) surveys hybrid securities in the Philippine capital markets; (ii) describes their role in regulatory arbitrage; (iii) surveys rules on debt–equity distinction formulated by judges; (iv) proposes a general principle underlying the debt–equity distinction based on the concept of the equity-holder as "bearer of the residual risk"; and (v) develops a tool for classifying hybrid securities through a scoring system which ranks these securities based on their proximity to debt or equity. This paper will then apply this tool in developing a debt–equity continuum that visually illustrates which Philippine hybrid security has predominant debt or equity features. In doing this, this paper can assist practitioners manage legal risks arising from, as well as assist judges and regulators in deciding disputes about, the debt–equity classification problem.

I. INTRODUCTION

Distinguishing a loan from a share of stock, interest from dividend, or creditor from stockholder (the "**Debt–Equity Classification Problem**") appears at first glance to be a simple matter. One category is associated with obligations, the other with ownership. However, difficulties arise when we deal with: (i) complex financial instruments having the characteristics of both debt and equity, or "**Hybrid Instruments**", and (ii) aggressive financial engineering and tax planning techniques that exploit the differential regulatory

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treatment between debt and equity, an activity called "**Regulatory Arbitrage**". Consider the classification of the following instruments issued by Philippine banks and publicly listed corporations since 2014: (i) perpetual bonds, (ii) unsecured subordinated debt, (iii) equity-linked notes, (iv) fixed-rate cumulative redeemable preferred stock, (v) contingent convertible bonds or debentures, and (vi) catastrophe bonds.[1] Between the plain vanilla common stock and the ordinary loan is a continuum of complex financial instruments, each having a particular degree of proximity to either pure debt or pure equity.

The correct classification of these Hybrid Instruments depends on the relevant regulatory framework within which the classification matters. What is equity for purposes of bank regulatory capital may be debt for purposes of taxation;[2] what is debt for purposes of taxation may be equity for purposes of foreign ownership limitation;[3] and so on. Often, the debt–equity distinction is merely implied—i.e. where a statute regulates debt alone, it does not regulate equity in the same manner, and vice versa. This creates an implicit differential treatment between the two instruments, and there arises an unintended consequence whereby one is more economically advantageous, or has less transaction cost, than the other.[4] This provides Regulatory Arbitrage opportunities whereby a party may create a Hybrid Instrument with the economic substance of equity, but the legal form (and privileges) of debt, or vice versa. Moreover, this makes some financial instruments with ambiguous or hybrid nature a source of legal risk, inconsistent interpretations, and misclassifications.

The Debt–Equity Classification Problem has important legal implications in many areas of Philippine business law and policy, including: (i) bank regulation, (ii) corporate taxation, (iii) competition law, (iv) foreign

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[1] *See infra* Part II for a description and example of each Hybrid Instrument.

[2] *See infra* the discussion on the issuance of Trust Preferred Securities in Part III.

[3] Consider a hypothetical loan agreement which bequeaths control rights to a foreign lender over an entity engaged in a nationalized economic activity. The loan is tax-deductible, but it may possibly constitute simulated ownership rights in violation of the Anti-Dummy Law. *See, e.g.* the Court of Appeals Decision on the legality of the Rappler Philippine Depositary Receipts in *Rappler, Inc. v. Sec. & Exch. Comm'n Special Panel*, CA-G.R. SP. No. 154292, (Ct. of Appeals July 26, 2018).

Another instance is a loan extended by a foreign investor to a Filipino corporation with option to convert debt into equity, as detailed in Manila Bulletin, *SEC probes loan agreement in Medical City row*, MANILA BULL., Oct. 10, 2018, *available at* https://business.mb.com.ph/2018/10/10-sec-probes-loan-agreement-in-medical-city-row (last visited Dec. 21, 2018). Prior to the exercise of conversion, the loan is tax-deductible, but for purposes of the Anti-Dummy Law, the convertibility feature may raise doubts as to whether the investment is purely one of debt.

[4] *See, e.g.* differential tax treatment of debt and equity in Part IV, *infra.*

ownership policy, (v) electric power industry regulation, and (vi) securities regulation. First, the *Bangko Sentral ng Pilipinas* ("**BSP**") has adopted the *Basel III Capital Adequacy Framework* ("**Basel III**") issued by the Basel Committee on Banking Supervision ("**BCBS**"), which specifies Hybrid Instruments that qualify as regulatory capital for depository institutions. Second, the *Tax Reform Act of 1997* or Republic Act (R.A.) No. 8424 ("**Tax Code**"), as amended by the *Tax Reform for Acceleration and Inclusion* ("**TRAIN**") or R.A. No. 10963, imposes differential tax treatment for debt instruments and shares of stock, and their respective interests and dividends. Third, the 1987 Constitution and the Foreign Investment Negative List impose foreign ownership limitations in certain economic activities on the basis of "capital", and the *Anti-Dummy Law* or Commonwealth (Com.) Act No. 108 criminalizes the simulation of capital to feign compliance with foreign ownership restrictions. Fourth, various corporate ownership limitations and thresholds of corporate control privilege equity-based relationships over debt-related interests, such as: (i) the Directors, Officers, Stockholders, and Related Interest rules and Single Borrower Limit rules under the *General Banking Law* and the *Manual of Regulation for Banks* ("**MORB**"); (ii) merger notification thresholds and mechanisms for detecting dominant market positions under the *Philippine Competition Act* and the rules and regulations of the Philippine Competition Commission; (iii) cross-ownership rules under the *Electric Power Industry Reform Act of 2001* and the rules and regulations of the Department of Energy; and (iv) the mandatory tender offer rule and beneficial ownership reporting obligations under the *Securities Regulation Code* ("**SRC**").

A Hybrid Instrument is either debt or equity; it cannot be partially debt, partially equity, or both (the "**All-or-Nothing Approach**").[5] Legal, regulatory, or tax questions regarding the treatment of a Hybrid Instrument therefore requires general guidance on debt–equity distinction. In Philippine law and policy, the debt–equity distinction for compliance with Basel III regulatory capital is the most systematic guidance issued or adopted by a government agency,[6] but this classification system is for a specific technical purpose in the financial sector and has no application to other regulatory contexts. International and domestic accounting standards have debt–equity classification rules,[7] but these are not legally binding unless adopted by

[5] "[The 'all or nothing' analytic] framework requires that a security be classified as either all debt or all equity—'instruments have not been fragmented into part equity and part debt.'" Roger B. Madison, Jr., *The deductibility of "interest" on hybrid securities*, 39 TAX LAW., 465–517, 478 (1986).

[6] *See* BSP Circ. No. 781 (2013), the Basel III Implementing Guidelines on Minimum Capital Requirements; *Id.*, app. 63b/Q-46 (Risk-based Capital Adequacy Framework for the Philippine Banking System), pt. II (Qualifying Capital).

[7] *See infra* Part VI(B)(2).

regulatory agencies or courts. The debt–equity distinction in Philippine taxation has relied, for the most part, on Court of Tax Appeals ("**CTA**") cases, and these doctrines have not been tested yet before the Supreme Court.[8]

This paper proposes a systematic method of dealing with the Debt–Equity Classification Problem, with a focus on the area where it has the most obvious impact: corporate taxation. In doing so, this paper can assist managers, corporate lawyers, and other decision-makers in managing legal risks arising from, and assist judges and regulators in deciding disputes about, the Debt–Equity Classification Problem. In order to achieve this, this paper shall:

1. Survey common Hybrid Instruments currently or intended to be in circulation in Philippine capital markets, with a description of their features;

2. Describe and illustrate the role of Hybrid Instruments in Regulatory Arbitrage;

3. Summarize the differential tax treatment between debt and equity instruments;

4. Survey some rules on the Debt–Equity Classification Problem formulated by judges;

5. Propose a general principle underlying the debt–equity distinction based on the concept of the equity-holder as "bearer of the residual risk"; and

6. Develop a systematic tool for classifying Hybrid Instruments by: (i) surveying the criteria that functionally define pure debt and pure equity; (ii) identifying the generic kinds of Hybrid Instruments that arise by combining these criteria; (iii) developing a scoring system that describes whether a Hybrid Instrument has predominant debt or equity features; and (iv) developing a debt–equity continuum that visually plots Hybrid Instruments in terms of their proximity to either pure debt or pure equity.

[8] *See infra* Part V for overview of the debt–equity distinction rules of the CTA.

II. PHILIPPINE HYBRID INSTRUMENTS

A. Perpetual bond

A perpetual bond is a bond with no defined term or maturity.[9] A corporation that issues a perpetual bond may pay coupons on the bond for an indefinite period in the future. Unless otherwise provided, the issuer has no obligation to redeem it and the bond does not grant voting or control rights over the issuing corporation. Being a bond (instead of an ordinary debt instrument), it is usually issued to the public. Other names given to this instrument are "perps" or "consols". To illustrate, on January 10, 2018, the International Container Terminal Services, Inc. offered the issuance of additional senior perpetual securities of its subsidiary, Royal Capital B.V., in the aggregate amount of USD 50,000,000, with the following features:

Issuer:	Royal Capital B.V.
Guarantor:	International Container Terminal Services, Inc.
Issuance:	Senior Guaranteed Perpetual Capital Securities
Amount:	Up to USD 50 million
Maturity:	Perpetual, callable on May 5, 2022 and any distribution payment date after the first call date
Distribution rate:	5.875% per annum, payable semi-annually in arrears on May 5 and November 5 of each year

[9] *See, e.g.* perpetual notes issued by Ayala, Megaworld, and Petron: (i) Doris Dumlao-Abadilla, *Ayala issues landmark $400M perpetual notes*, PHIL. DAILY INQUIRER, Sept. 7, 2017, *available at*: https://business.inquirer.net/236394/ayala-issues-landmark-400m-perpetual-notes (last visited Dec. 21, 2018); (ii) Doris Dumlao-Abadilla, *Megaworld taps offshore bond market*, PHIL. DAILY INQUIRER, Apr. 7, 2018, *available at* https://business.inquirer.net/248741/megaworld-taps-offshore-bond-market (last visited Dec. 21, 2018; and (iii) Doris Dumlao, *Petron raises $500M from sale of perpetual bonds*, PHIL. DAILY INQUIRER, Jan. 31, 2013, *available at* http://business.inquirer.net/105265/petron-raises-500m-from-sale-of-perpetual-bonds (last visited Dec. 21, 2018).

Use of proceeds:	Financing of acquisitions and capital expenditures and for general corporate purposes[10]

B. Unsecured subordinated debt

An unsecured subordinated debt is a liability that has the least priority of payment compared to other liabilities in the event of insolvency of the issuer corporation.[11] Being unsecured, the holder of said debt has no other recourse against the issuer except the corporations' residual assets. Since subordinated debts are paid last, they are more risky than ordinary debts, and therefore call for higher yields to investors. This type of debt is considered under Basel III to be part of the supplementary capital of a bank because of its loss absorbing capacity.[12] Subordinated debt is also called "mezzanine debt".[13]

To illustrate, on May 12, 2014, the Philippine Savings Bank offered the issuance of PHP 3 billion Unsecured Subordinated Notes, which are due on August 23, 2024. The notes bear interest at 5.50% per annum from and including May 23, 2014 to but excluding August 23, 2024. The interest is payable quarterly in arrears. The notes qualify as Tier 2 Capital, in accordance with the revised risk-based capital adequacy framework for the Philippine banking system to conform to Basel III, under BSP Circular No. 781 s. 2013, BSP Circular No. 826 s. 2014 on risk disclosure requirements for the loss absorption features of capital instruments, Section X119 of the MORB, and other issuances of the BSP.[14]

C. Fixed-rate cumulative redeemable preferred stock

A fixed-rate cumulative redeemable preferred stock is a share of stock that has no voting rights except residual control rights guaranteed by Section 6 of the Corporation Code.[15] The redeemable feature allows the issuer to buy

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[10] ICTSI's Phil. Stock Exch. (PSE) Disclosure Form 4-30 ("Material Information/Transactions") (C00149-2018) dated Jan. 11, 2018.

[11] BSP Manual of Regulations for Banks [hereinafter, "MORB"], § X119.1.

[12] MORB, § X119.

[13] SUE WRIGHT, INTERNATIONAL LOAN DOCUMENTATION 6, § 1, ¶ 3.3 (Springer, 2006).

[14] PSBank Offering Circular for P3,000,000,000 5.50% Unsecured Subordinated Notes Qualifying as Tier 2 Capital Due August 23, 2024 Callable in August 23, 2019 Issue Price 100%, *available at* https://www.psbank.com.ph/Contents/img/PSBank%20Tier%202%20Offering%20Circular%20%2012%20May%20201482193173-6d90-412a-89e7-365dbcbdd1C4.pdf (last visited Dec. 14, 2018).

[15] The provision states:

back the stock at a certain price and retire it.[16] The cumulative feature is a stipulation providing that if any dividend payments were unpaid in the past, the dividends owed must be paid out to cumulative preferred shareholders first.[17] The fixed-rate feature guarantees a certain rate of return on the stock.[18] To illustrate, on January 26, 2016, Philippine Long Distance Telephone Company approved the creation of 20,000 shares of Non-Voting Serial Preferred Stock, constituted into Series KK 10% Cumulative Convertible Preferred Stock, with an issue price per share of PHP 10, which is the par value.[19]

"Where the articles of incorporation provide for non-voting shares in the cases allowed by this Code, the holders of such shares shall nevertheless be entitled to vote on the following matters:

1. Amendment of the articles of incorporation;
2. Adoption and amendment of by-laws;
3. Sale, lease, exchange, mortgage, pledge or other disposition of all or substantially all of the corporate property;
4. Incurring, creating or increasing bonded indebtedness;
5. Increase or decrease of capital stock;
6. Merger or consolidation of the corporation with another corporation or other corporations;
7. Investment of corporate funds in another corporation or business in accordance with this Code; and
8. Dissolution of the corporation."

[16] CORP. CODE, § 8 states:

"Redeemable shares may be issued by the corporation when expressly so provided in the articles of incorporation. They may be purchased or taken up by the corporation upon the expiration of a fixed period, regardless of the existence of unrestricted retained earnings in the books of the corporation, and upon such other terms and conditions as may be stated in the articles of incorporation, which terms and conditions must also be stated in the certificate of stock representing said shares."

[17] "A cumulative preferred share entitles the owner thereof to payment of current dividends as dividends in arrears." Crucillo v. Office of the Ombudsman, G.R. No. 159876, 525 SCRA 636, n.63 (2007).

[18] *See, e.g.* the 16% annual yield guarantee for the PHP 40 million infusion of the Development Bank of the Philippines in *Crucillo v. Office of the Ombudsman.*

[19] PLDT's Sec. & Exch. Comm'n (SEC) Form 17-C (C00408-2016) dated Jan. 26, 2016, with attached PSE Disclosure Form 4-15 ("Creation and Issuance of New Equity Security").

D. Contingent convertible bond or debenture

A convertible bond is a bond with a convertibility feature allowing the holder to transform the bond into a specified number of shares in the issuing corporation, at a stipulated conversion price.[20] A contingent convertible bond differs from an ordinary convertible bond because the conversion does not depend on the discretion of the bondholder, but depends on the occurrence of a pre-defined trigger event.[21] Other names include "catastrophe equity put option", "contingent surplus note", or "standby loan".[22] Contingent convertible bonds have not yet gained traction in the Philippine capital markets. An example of an ordinary convertible bond, on February 1, 2017, Roxas Holdings, Inc. approved the issuance of Convertible Note between Roxas Holdings, Inc. (RHI) and First Pacific Natural Resources Holdings, B.V., with the following features:

Principal:	PHP 523,750,000.00
Coupon:	3
Conversion ratio:	Initially set at One Common Share for every PHP 4.19 of the value of the Convertible Note
Conversion period:	Date of issuance of the Convertible Note up to & including the 10th business day immediately preceding the Redemption Date of December 31, 2017
Conversion price:	PHP 4.19

[20] INTERNATIONAL MONETARY FUND [hereinafter, IMF], HANDBOOK ON SECURITIES STATISTICS 20, 62, 144 (2015), *available at* https://www.imf.org/external/np/sta/wgsd/pdf/hss.pdf (last visited Dec. 20, 2018).

[21] *Coco bonds have not lived up to their promise*, ECONOMIST, Apr. 21, 2018, *available at* https://www.economist.com/finance-and-economics/2018/04/21/coco-bonds-have-not-lived-up-to-their-promise (last visited Dec. 21, 2018).

[22] Business Dictionary, *What is contingent capital?*, *at* http://www.businessdictionary.com/definition/contingent-capital.html (last visited December 21, 2018).

Use of proceeds:	Financing of acquisitions and capital expenditures and for general corporate purposes[23]

E. Equity-linked note

An equity-linked note is a note that gives participation rights over the profits of the issuer corporation.[24] Typically, it combines guaranteed fixed returns plus variable returns which depend on the success or failure of the business venture. The principal amount is repayable over a certain period of time. To illustrate, Emperador Inc. previously approved a private placement transaction with GIC Private Limited, through the latter's affiliate Arran Investment Private Limited. GIC Private Limited is the sovereign wealth fund of Singapore. The transaction involves the issuance of equity-linked securities aggregating to PHP 22 billion together with the issuance of other shares.[25] Under the equity-linked securities agreement executed between the parties, Emperador Inc. would issue new common shares to Arran Investment to cover the accrued interest due under the equity-linked securities.[26]

F. Catastrophe bond

A catastrophe bond is a bond typically issued by an insurance company with a stated maturity and cashflow stream, but with a provision that if a stipulated catastrophe occurs, the issuing insurance corporation need not repay the principal to the bondholder.[27] The insurer will in turn utilize the principal to pay claim-holders affected by the catastrophe in question. The catastrophe bond allows the insurer to allocate risk to the investors of the bond. To illustrate, the World Bank and the Japan International Cooperation Agency (JICA) have proposed emergency funding for insuring disaster risk in vulnerable communities, including the following instruments: (i) Catastrophe Bond, (ii) Catastrophe Deferred Drawdown Option, and (iii) Disaster Recovery Stand-by Loan, which was entered into by JICA in 2014 due to the

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[23] Roxas Holdings, Inc.'s SEC Form 17-C (C01045-2017) dated Feb. 24, 2017, with attached PSE Disclosure Form 4-16 ("Issuance of Debt Securities").

[24] IMF, HANDBOOK ON SECURITIES STATISTICS 21, ¶ 3.41 (2015), *available at* https://www.imf.org/external/np/sta/wgsd/pdf/hss.pdf (last visited Dec. 20, 2018).

[25] Emperador Inc.'s SEC Form 17-C (C05834-2014) dated Nov. 7, 2014, with attached PSE Disclosure Form 7-1 ("Notice of Annual or Special Stockholders' Meeting").

[26] Emperador Inc.'s SEC Form 17-C (C07154-2017) dated Nov. 28, 2017, with attached PSE Disclosure Form 4-30 ("Material Information/Transactions").

[27] Risk Management Solutions, *Cat Bonds Demystified* (2012), *available at* https://forms2.rms.com/com/rs/729-DJX-565/images/cm_cat_bonds_demystified.pdf (last visited Dec. 21, 2018).

damage wrought by Typhoon Haiyan.[28] The proposed issuance of catastrophe bonds was motivated by natural disasters occurring frequently in the Philippines.

III. REGULATORY ARBITRAGE THROUGH HYBRID INSTRUMENTS

Why do firms issue Hybrid Instruments? One of the common motives documented in tax and corporate governance research is Regulatory Arbitrage. This passage from the World Accounting Report summarizes the role of Hybrid Instruments in Regulatory Arbitrage transactions:

> The dream of every finance executive is a hybrid instrument, which is classified as equity when calculating gearing ratios, but does not dilute ordinary shares and share price, is as cheap as debt, and whose return ranks as interest for tax purposes.[29]

Ernst & Young in its 2016 Annual Report states that the "holy grail" of Hybrid Instruments is "an instrument regarded as a liability by the tax authorities (such that costs of servicing it are tax deductible) but treated as equity for accounting and/or regulatory purposes (so that the instrument is not considered as a component of net borrowing)."[30]

One prominent example of the issuance of Hybrid Instruments with an underlying Regulatory Arbitrage motive was the offering by banks of Trust Preferred Securities ("**TruPS**") before the 2008 Global Financial Crisis. The process of issuance is as follows: **First**, a bank holding company ("**Bank HoldCo**") sets up a Special Purpose Entity ("**SPE**"), which is an independent corporate entity having separate personality from the Bank HoldCo. **Second**, Bank HoldCo subscribes to 100% of the common stock of the SPE, hence becoming a wholly-owned subsidiary of Bank HoldCo. As consideration for the subscription, Bank HoldCo assigns "junior subordinated debt" to the SPE. The junior subordinated debt represents a claim by Bank HoldCo

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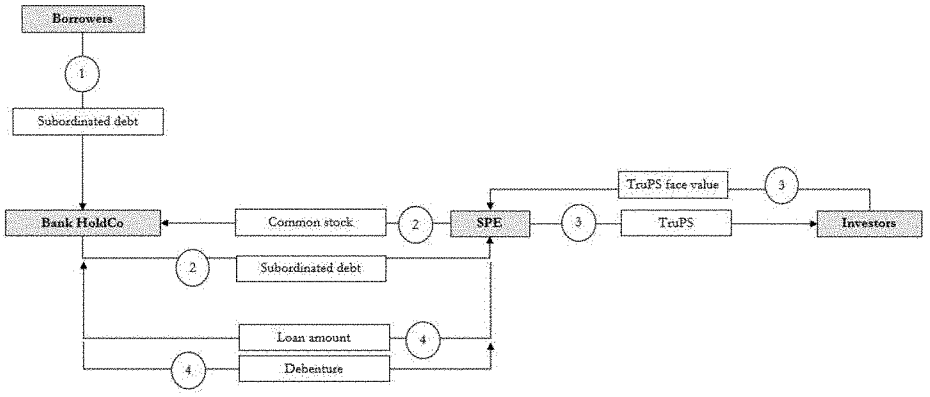
[28] Japan Ministry of the Environment, *Sustainable Disaster Risk Finance in the Philippines: Restoration Activities after Typhoon Haiyan*, at 3, *available at* https://www.env.go.jp/en/earth/cc/casestudy/casestudy2_4.pdf (last visited Dec. 14, 2018).

[29] Kimberley Crook, *The conceptual distinction between liabilities and equity: a new approach required* (1998) at 15, *available at* https://ir.canterbury.ac.nz/bitstream/handle/10092-13107/Crook_1998_ thesis.pdf?sequence=1 (last visited Dec. 20, 2018) *citing* WORLD ACCT'G REPORT, May 1991, at 11.

[30] Neil Fargher, et al., *Accounting for financial instruments with characteristics of debt and equity: Finding a way forward*, AASB Academic Forum, November 24, 2016, at 9, *available at* https://www.aasb.gov.au/admin/file/content102/c3/Accounting_for_financial_instruments_with_characteristics_AASBRF2016_1482454282783.pdf (last visited Dec. 20, 2018).

against borrowers, and is therefore an asset of Bank HoldCo. In assigning it to the SPE, the junior subordinated debt becomes the SPE's sole asset. **Third**, the SPE issues TruPS to investors, who will hold a claim against the returns on the junior subordinated debt. The TruPS are redeemable, cumulative preferred shares. When the investors subscribe to TruPS, they pay the face value of the TruPS, which forms part of the proceeds of the subscription. **Fourth**, the SPE loans out the proceeds of TruPS subscriptions to Bank HoldCo. Bank HoldCo then issues "deeply subordinated deferrable interest debentures" to the SPE as a consideration for the loan. **Fifth**, Bank HoldCo pays interest on these debentures (now held by the SPE). **Sixth**, the SPE uses the interest income on the debentures to fund the returns on the TruPS to its investors.[31] This securitization arrangement is shown in **Figure 1**.

Figure 1. Securitization Transaction involving Trust Preferred Securities



This securitization transaction has the following advantages: (i) the interest paid by Bank HoldCo to SPE on the debentures is deductible from its gross income,[32] and (ii) the TruPS is considered a Tier 1 Capital instrument under *Basel I*.[33] From the viewpoint of the tax authority, the Hybrid Instrument is considered a debt security. However, from the viewpoint of the monetary authority, it is considered regulatory capital.

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[31] Nicole M. Boyson, et al., *Why Don't All Banks Practice Regulatory Arbitrage? Evidence from Usage of Trust-Preferred Securities*, 29 REV. FIN. STUD. 7, 1827 (2016), *available at* https://pdfs.semanticscholar.org/691d/b5885f97c8ff1c13ee6ce5713504eb19348b.pdf (last Visited Dec. 20, 2018).

[32] *Id.* at 1824.

[33] *Id* at 1827.

IV. Differential Tax Treatment of Debt and Equity

In Philippine corporate taxation, debt and equity instruments have differential tax treatments, which in turn give rise to unintended economic preferences for certain kinds of securities.[34] Two kinds of income are taxable: (i) passive income and (ii) trading gain. Passive income consists of: (i) interest in the case of debt instruments, and (ii) dividends in the case of shares of stock. With regard to interest: (i) for individuals, the tax rate is generally 20%, with the exception of non-resident alien individuals not engaged in business in the Philippines, with a tax rate of 25%, and (ii) for corporations, the tax rate is generally 20%, with the exception of non-resident foreign corporations, with a tax rate of 30%. With regard to dividends: (i) for individuals, the tax rate is generally 10%, with the exception of non-resident aliens engaged in business, with a tax rate of 20%, and non-resident alien not engaged in business, with a tax rate of 25%, and (ii) for corporations, dividends are generally exempt (being intercorporate dividends), with the exception of non-resident foreign corporations, with a tax rate of 15% or 30% depending on the applicability of the tax sparing rule. See **Table 1.A.**, columns A and B.

With regard to trading gain, one must distinguish two kinds of debt instruments: (i) those with maturity not greater than five years, and (ii) those with maturity greater than five years. There are also two kinds of shares of stock: (i) those not sold through the local stock exchange, and (ii) those sold through the local stock exchange. For debt instruments with maturity not greater than five years, the tax rates are as follows: (i) for individuals, the rate is generally 0 – 35% depending on the tax bracket, with the exception of non-resident alien individuals not engaged in business, with a rate of 25%, and (ii) for corporations, the rate is 30%. On the other hand, for debt instruments with maturity greater than five years, trading gain is exempt from tax. For shares of stock not sold through the local stock exchange, the rate is 15% on net capital gain, with the exception of foreign corporations, with a rate of 5 – 10% on net capital gain. For shares of stock sold through the local stock exchange, the tax rate is 0.60% on gross selling price. See **Table 1.B.**, columns C, D, E, and F.

Income tax on interest from debt instruments and on dividends from shares of stock have the following marginal tax rate differentials: (i) for individuals, a rate differential of 10% for citizens and resident alien individuals, but 0% rate differential for a non-resident alien individual; and (ii)

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[34] The discussion of CTA cases in Part V, *infra*, illustrates how taxpayers use Hybrid Instruments to exploit the differential tax treatment of debt and equity.

for corporations, a rate differential of 20%, but 0% or 15% rate differential for non-resident foreign corporations depending on the applicability of the tax sparing rule. Income tax on trading gains from the sale or exchange of debt and equity instruments has the following marginal tax rate differentials: **First**, for debt instruments with maturity of less than or equal to five years vis-à-vis shares of stock not sold through the local stock exchange: (i) for individuals, a tax rate differential of 20% maximum, but 10% for non-resident alien individual not engaged in business; and (ii) for corporations, 15% tax rate differential for domestic, and 20% – 25% for foreign. **Second**, for debt instruments with maturity of less than or equal to five years vis-à-vis shares of stock sold through the local stock exchange, debt instruments will generally yield significantly higher tax amounts provided there is a positive trading gain. See **Table 2** for sample computation. **Third**, for debt instruments with maturity greater than five years vis-à-vis shares of stock not sold through the local stock exchange: (i) for individuals and domestic corporations, a rate differential of -15%; and (ii) for foreign corporations, a differential of -5% to -10%. **Fourth**, for debt instruments with maturity greater than five years vis-à-vis shares of stock sold through the local stock exchange: a rate differential of -0.6% on gross selling price.

The differential tax treatment between debt and equity is summarized in **Table 1.A**, **Table 1.B**, and **Table 2**. A positive rate differential signifies that the tax rate on debt instrument is higher compared to the tax rate on equity instrument, while a negative rate differential signifies that the tax rate on debt instrument is lower compared to the tax rate on equity instrument.

Table 1. Differential tax treatment of debt and equity.[35]

A. By interest or dividend income

Taxpayers			Interest or Dividend Income		
			Debt (e.g. bond)	Equity (i.e. share of stock)	Difference
			A	B	A−B
Individual	Citizen	Resident	20%	10%	10%
		Non-Resident	20%	10%	10%
	Alien	Resident	20%	10%	10%
		Non-Resident (Engaged in business)	20%	20%	0%
		Non-Resident (Not engaged in business)	25%	25%	0%
Corporation	Domestic		20%	Exempt	20%
	Foreign	Resident	20%	Exempt	20%
		Non-Resident	30%	30% / 15%	0% / 15%

[35] TAX CODE, §§ 24(A)(2), 24(B)(1), 24(B)(2), 24(C), 25(A)(1), 25(A)(2), 25(A)(3), 25(B), 27(A), 27(D)(1), 27(D)(2), 27(D)(4), 28(A)(1), 28(A)(7)(a), 28(A)(7)(c), 28(A)(7)(d), 28(B)(1), 28(B)(5)(b), 28(B)(5)(c), 32(B)(7)(g), 127(A).

B. By trading gain

Taxpayers			Trading Gain							
			Debt (e.g. bond)		Equity (i.e. share of stock)		Difference			
			Term ≤ 5 yrs.	Term > 5 yrs.	Not sold via local stock exch.	Sold via local stock exch.				
			C	D	E	F	C−E	C−F	D−E	D−F
Individual	Citizen	Resident	0 – 35% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	-15% to 20%	(see Table 2)	-15%	-0.6% on gross selling price
		Non-Resident	0 – 35% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	-15% to 20%		-15%	-0.6% on gross selling price
	Alien	Resident	0 – 35% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	-15% to 20%		-15%	-0.6% on gross selling price
		Non-Resident (Engaged in business)	0 – 35% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	-15% to 20%		-15%	-0.6% on gross selling price
		Non-Resident (Not engaged in business)	25% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	10%		-15%	-0.6% on gross selling price
Corporation	Domestic		30% on trading gain	Exempt	15% on net capital gain	0.60% on gross selling price	15%		-15%	-0.6% on gross selling price
	Foreign	Resident	30% on trading gain	Exempt	5 – 10% on net capital gain	0.60% on gross selling price	20% to 25%		-5% to -10%	-0.6% on gross selling price
		Non-Resident	30% on trading gain	Exempt	5 – 10% on net capital gain	0.60% on gross selling price	20% to 25%		-5% to -10%	-0.6% on gross selling price

Table 2. Differential tax treatment of trading gain on debt with maturity less than or equal to 5 years vis-a-vis share sold through local stock exchange.

Acquisition Cost (PHP)	Selling Price (PHP)	Trading Gain (PHP)	Income tax on sale of debt instrument with maturity ≤ 5 yrs. (PHP)			Income tax on sale of share of stock via local stock exch. (PHP)	Difference (PHP)		
			Individual	Non-resident individual (Not engaged in business)	Corp.	0.60% × b			
a	b	b−a	35% max × (b−a)	25% × (b−a)	30% × (b−a)				
			c	d	e	f	c−f	d−f	e−f
1,000	1,000,000	999,000	149,850	249,750	299,700	6,000	143,850	243,750	293,700
10,000	100,000	90,000	13,500	22,500	27,000	600	12,900	21,900	26,400
100,000	10,000	-90,000	-13,500	-22,500	-27,000	60	-13,560	-22,560	-27,060
1,000,000	1,000	-999,000	-149,850	-249,750	-299,700	6	-149,856	-249,756	-299,706

V. "*JUS RESIDUUM*" AS THE GENERAL PRINCIPLE UNDERLYING DEBT–EQUITY DISTINCTIONS

This paper proposes that equity-holders differ mainly from debt-holders in the fact that they are "bearers of the residual risk" in the enterprise. A Hybrid Instrument that grants its holder *jus residuum* should be treated as an equity instrument. "***Jus residuum***" refers to the "right to the remainder"—i.e. right to the residual assets or residual value of the issuing firm. To support this claim, some concepts from financial theory will be borrowed, and this paper will illustrate the manifestations of *jus residuum* using examples from (i) Philippine corporate law doctrines about the nature of stock ownership, (ii) general accounting principles, (iii) the International Monetary Fund's ("**IMF**") guidelines on securities statistics, and (iv) Basel III's definition of regulatory capital. However, to do this, we must first dissect the idea of how plain vanilla shares of stock, like common stock, can become Hybrid Instruments.

A. Hybrid Instruments as "Unbundled" Stock Ownership Rights

Under Philippine civil law, ownership consists of the following bundle of rights or attributes (the "**Bundle of Rights Doctrine**"): (i) *jus possidendi* or the right to possess the thing owned, (ii) *jus utendi* or the right to receive from the thing what it produces, (iii) *jus fruendi* or the right to the fruits, (iv) *jus abutendi* or the right to consume the thing by its use, (v) *jus disponendi* or the power of the owner to alienate, encumber, transform and even destroy the thing owned, and (vi) *jus vindicandi* or the right to exclude from the possession of the thing owned any other person to whom the owner has not transmitted such thing.[36]

This bundle of ownership rights is capable of being "unbundled", often through contracts (e.g. an option to buy coupled with a long-term lease). Thus, in *Philippine Banking Corp. v. Lui She*,[37] a "virtual transfer of ownership" may take place whereby the "owner divests himself in stages". The Supreme Court provides:

> It is just as if today the possession is transferred, tomorrow, the use, the next day, the disposition, and so on, until ultimately all the rights of which ownership is made up are consolidated in an alien.[38]

The Bundle of Rights Doctrine is also applicable to shares of stock. Thus, the bundle of rights of a stockholder to (i) vote, (ii) receive dividends, (iii) receive distributions upon liquidation of the corporation, and (iv) inspect the books of the corporation,[39] among others, can in turn be unbundled through agreements, such as voting trusts. In *Lee v. Court of Appeals*,[40] the Supreme Court recognizes that control rights may be divorced from other attributes of stock ownership, as follows:

> By its very nature, a voting trust agreement results in the **separation of the voting rights of a stockholder from his other rights** such as the right to receive dividends, the right to inspect the books of the corporation, the right to sell certain interests in the assets of the corporation and other rights to which a stockholder may be entitled until the liquidation of the corporation.

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[36] Austria-Magat v. Ct. of Appeals, G.R. No. 106755, 375 SCRA 556 (2002); Distilleria Washington, Inc. V. La Tondeña Distillers, Inc., G.R. No. 120961, 280 SCRA 116 (1997).

[37] G.R. No. 17587, 21 SCRA 52 (1967).

[38] *Id.*

[39] Cojuangco v. Roxas, G.R. No. 91925, 195 SCRA 797 (1991).

[40] G.R. No. 93695, 205 SCRA 752 (1992).

> However, in order to distinguish a voting trust agreement from proxies and other voting pools and agreements, it must pass three criteria or tests, namely: (1) that **the voting rights of the stock are separated from the other attributes of ownership**; (2) that the voting rights granted are intended to be irrevocable for a definite period of time; and (3) that the principal purpose of the grant of voting rights is to acquire voting control of the corporation.[41]

Similarly, under the SRC and the 2015 Implementing Rules and Regulations of the Securities Regulation Code ("**SRC Rules**"), legal title and beneficial title over a security may be separated,[42] as in the case of trusts in general; and beneficial title, in turn, is a bundle of two privileged rights: (i) voting power and (ii) investment returns, including power to dispose of the security.[43] SRC Rule 3.1.2. states:

> Beneficial owner or beneficial ownership means any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting power (which includes the power to vote or direct the voting of such security) and/or investment returns or power (which includes the power to dispose of, or direct the disposition of such security)[.]

It is easy to imagine how the Bundle of Rights Doctrine and the principle of unbundling stockholder rights apply to Hybrid Instruments. A fixed-rate cumulative redeemable preferred stock is a share of stock divested of some stock ownership attributes, specifically: (i) some voting or control rights and (ii) some rights to surplus profits of the corporation. Similarly, an equity-linked note is a debt instrument coupled with some stock ownership attributes, such as "dividend-like" returns or variable returns that depend on the surplus profits of the corporation. In short, Hybrid Instruments arise because of the unbundling of stock ownership rights.

B. Residual Risk Theory of Equity

If Hybrid Instruments are unbundled stock ownership rights, what component rights constitute the core features of shares of stock? In financial theory, the answer is "residual risk" coupled with the right to vote (the "**Residual Risk Theory**"). This is exemplified by the following statements:

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[41] *Id. citing* 5 WILLIAM FLETCHER, CYCLOPEDIA OF THE LAW ON PRIVATE CORPORATIONS 331, § 2075 (1976) *citing* Tankersly v. Albright, 374 F. Supp. 538 (1974). (Emphasis supplied.)

[42] Sec. Reg. Code Rule 3.1.2.

[43] *Id.*

a. "[W]hy do shareholders alone have voting rights? [...] The reason is that shareholders are the residual claimants to the firm's income."[44]

b. ""The right to vote [...] follows the residual claim. When the firm is in distress, the [common] shareholders' claim goes under water, they lose the appropriate incentives to maximize [firm value] on the margin. Other groups, such as preferred stockholders or creditors, then receive [decision rights] until their claims are satisfied."[45]

c. "[Shareholders] are the 'residual claimants,' who bring to the firm their special ability at risk-bearing [...] [There is] a persuasive economic rationale for why voting rights should be accorded only (or at least primarily) to the residual claimants. Uniquely, the residual claimants of the firm are interested in the firm's overall profitability, whereas creditors and managers are essentially fixed claimants who wish only to see their claims repaid and who will logically tend to resist risky activities."[46]

d. "[G]iving control to the residual claimants will place the power to monitor the performance of participants in the firm and the power to control shirking, waste, and so forth in the hands of those who have the best incentive to use the power. . . . This viewpoint supports the conclusion that common shareholders should possess voting rights that, at a minimum, give them the power to select or remove the directors and, therefore, the indirect power to control the identity of top management."[47]

e. "I define a 'residual interest' in a firm to involve any situation in which the expected value of a contracting party's future dealings with the firm increases as the firm's value increases, and decreases as the firm's value decreases. These expectations can arise from explicit contract, from statutory entitlements, or from the

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[44] Bernard S. Black, *Corporate Law and Residual Claimants* (2001), at 1, *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1528437 (last visited Dec. 20, 2018) *citing* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 63, 67 (Harvard Univ. Press 1991).

[45] *Id.* at 2, *citing* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 69 (Harvard Univ. Press 1991).

[46] *Id.* at 2, *citing* JESSE H. CHOPER, JOHN C. COFFEE, JR., & RONALD J. GILSON, CASES & MATERIALS ON CORPORATIONS 33 (4th ed. 1995).

[47] *Id.* at 2, *citing* ROBERT C. CLARK, CORPORATE LAW 389–90 (1986).

> expectations and likelihoods that economists call 'implicit contracts.' A 'residual claimant' is anyone with a significant residual interest in the firm's future success or failure."[48]

One of the more well-known definitions of "residual risk" is that of Eugene F. Fama and Michael C. Jensen, who define it as the "difference between the stochastic inflows of resources and promised payments to agents."[49] According to them, those who bear this residual risk are called "residual claimants", such as stockholders.[50] Hence, a Hybrid Instrument that contains a "legally guaranteed return of amount borrowed" and "regular cash payments in the form of interest" (see **Table 3**) is actually a promised payment, and therefore does not contain a residual risk. Hence, the instrument is not equity, but debt, and the holder thereof a creditor. In the same manner, a Hybrid Instrument that does not give the issuer corporation a "legal obligation to repay the holder before liquidation" and an obligation to pay "returns on investment on a regular basis" (see **Table 3**) exposes the holder to residual risk, because his payoff would depend on whether the stochastic inflows of resources exceed the promised payments to agents.

1. Jus residuum *in Philippine corporate law doctrines on stock ownership*

The Securities and Exchange Commission ("**SEC**") defines the structure of the equity of a corporation, as follows:

> Equity Instrument includes an entity's issued ordinary shares, and options and warrants held by external parties to purchase those shares. There are many types of Share Capital, including ordinary shares, preferred shares, non-voting shares, participating shares and redeemable shares. The price of Share Capital is recorded at the amount that a corporation received in consideration for the issuance of shares, plus share premium or APIC, if any.[51]

The attribute of *jus residuum* in equity instruments is recognized in Philippine law, as evident in several legal provisions and case law. Supreme Court decisions recognize that shareholders, both common and preferred, are considered risk takers who invest capital in the business and who can look only to what is left after corporate debts and liabilities are fully paid,[52] and that

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[48] *Id.* at 14.

[49] Eugene F. Fama and Michael C. Jensen, *Separation of Ownership and Control*, 26 J. OF L. & ECON. 2, 301–325, 302.

[50] *Id.* at 303.

[51] SEC Op. No. 14-13 at 5.

[52] Republic Planters Bank v. Agana, G.R. No. 51765, 269 SCRA 1 (1997).

shares of stock represent residual ownership interest in the corporation.[53] The Corporation Code provides that the board of directors of a stock corporation may only declare dividends out of the unrestricted retained earnings,[54] i.e. after preserving a sufficient portion of equity for the payment of debts to creditors, among other obligations.

The *jus residuum* principle is closely related to the Trust Fund Doctrine, whereby "[t]here can be no distribution of assets among the stockholders without first paying corporate debts. [...] [A]ny disposition of corporate funds and assets to the prejudice of creditors is null and void."[55] And once all liabilities to creditors have been paid, the remaining assets are divided between and among the stockholders of the dissolved corporation depending on their proportional interest in the corporation and other contracts they may have entered.[56]

In the insolvency of banks, the amended charter of the Philippine Deposit Insurance Corporation under Republic Act ("**R.A.**") No. 3591 as amended by R.A. No. 10846, defines "residual asset" as "assets, in cash or in kind, to be turned over to the closed bank's stockholders of record, in proportion to their interest in the closed bank as of date of closure, after payment in full of liquidation costs, fees and expenses, and the valid claims and surplus dividends to all the creditors."[57] With regard to cooperatives, the Cooperative Development Authority defines "equity" as the "residual interest in the assets of the cooperative after deducting all its liabilities,"[58] which was adopted from the definition of "equity" of the International Accounting Standards Board and in the International Accounting Standards No. 32.[59]

2. Jus residuum *in General Accounting Principles*

There are three theories that explain the conceptual distinction between debt and equity in accounting,: (i) the Proprietary Theory, (ii) the Entity Theory, and (iii) the Residual Equity Theory.[60] First, the "Proprietary Theory" provides that equity, or "proprietorship", is the "net value of the

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[53] Commissioner of Internal Revenue v. Ct. of Appeals, G.R. No. 108576, 301 SCRA 152 (1999).

[54] CORP. CODE, § 43.

[55] Turner v. Lorenzo Shipping Corp., G.R. No. 157479, 636 SCRA 13 (2010).

[56] SEC Op. No. 14-29.

[57] Rep. Act No. 3591 as amended, § 5(r).

[58] CDA Mem. Circ. No. 006-15 (2015). Philippine Financial Reporting Framework for Cooperatives.

[59] SEC Op. No. 14-13, at 5.

[60] Kimberley Crook, *supra* note 29, at 20.

business to its proprietors." Assets are resources controlled by the proprietor, while liabilities are his obligations. Meanwhile, revenues and expenses represent changes in the proprietorship.[61] Thus:

Assets − Liabilities = Proprietor's Equity

Second, the "Entity Theory" provides that both stockholders and creditors are claimants to the entity's assets, and that they both have "equities in the entity"—i.e. they are both "equity holders". The only distinction is that creditor's equities are "fixed and contractual" while the stockholders' equities are "elastic and residual". Hence, there is no fundamental conceptual distinction between the two groups of claimants, and that they differ only based on the functional differences of their respective financial interests.[62] Thus:

Assets = Equities

Third, the "Residual Equity Theory" provides that fixed interests, or "interests requiring definite fixed amounts of cash disbursements in the future," are not part of Residual Equity. Fixed interests include: (i) liabilities and (ii) specific equities. Liabilities are obligations to creditors, while specific equities include the interests of non-participating preferred stockholders. Residual Equity, on the other hand, represents "indefinite variable amounts of cash disbursements in the future."[63] Thus:

Fixed Interests = Liabilities + Specific Equities

Assets − Fixed Interests = Residual Equity

Notwithstanding their points of difference, there is one underlying theme in distinguishing liabilities and equities: the distinction between "obligations", "fixed and contractual" payments, and "definite fixed amounts of cash disbursements in the future", on the one hand, and "elastic and residual" interests and "indefinite variable amounts of cash disbursements in the future", on the other hand. In short, these principles recognize *jus residuum* or residual risk as a core feature of equity.

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[61] *Id.* at 20–21.
[62] *Id.* at 22–23.
[63] *Id.* at 26–28.

3. Jus residuum *in IMF Securities Statistics Guidelines*

The IMF in its *Handbook on Securities Statistics* defines debt securities as having the following quantitative characteristics: (i) issue date; (ii) issue price; (iii) redemption price or face value; (iv) maturity or redemption date; (v) coupon rate that the issuer pays to the holders; (vi) coupon dates; and (vii) currency of denomination and settlement.[64] On the other hand, the features of equity securities are: (i) they are claims by shareholders on the net worth of the issuing corporation; (ii) either listed on a stock exchange or unlisted; (iii) issued on a specific issue date with a specific issue price; (iv) do not usually have a stated maturity; (v) usually issued in the domestic currency; and (vi) income in the form of dividends.[65]

From this perspective, a debt security is one where the "[i]ssuer is obliged to pay a specified amount of principal and interest to the owner", whereas an equity security is an "[a]cknowledgment of claims on the residual value of a corporation after the claims of all creditors have been met."[66] The IMF relies on the idea of "claims on the residual value" in defining equity instruments, and this is nothing other than the principle of *jus residuum.*

4. Jus residuum *in Basel III Bank Capital Structure*

The BCBS issued Basel III on December 2010, providing an international and voluntary capital adequacy framework for banks and defining the components of their bank regulatory capital.[67] On January 2013, the BSP adopted Basel III through its *Implementing Guidelines on Minimum Capital Requirements.*[68] One principle in defining which Hybrid Instruments should be included in the regulatory capital of banks is the ability to absorb losses at point of non-viability ("**PONV**").[69] Basel III's objective is to provide stronger capital buffers to withstand economic and financial stress.[70] To achieve this, only "capital that is available to absorb losses, at all times,

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[64] IMF, *supra* note 20, at 9.

[65] *Id.* at 11.

[66] *Id.* at 10.

[67] Bank for International Settlements, *Basel III rules text and results of the quantitative impact study issued by the Basel Committee, available at* https://www.bis.org/press/p101216.htm (last visited Dec. 12, 2018).

[68] BSP Mem. No. M-2013-008, at 1.

[69] BSP Circ. No. 781 (2013), the Basel III Implementing Guidelines on Minimum Capital Requirements; *Id.,* app. 63b/Q-46 (Risk-based Capital Adequacy Framework for the Philippine Banking System), pt. II (Qualifying Capital), annexes E & F.

[70] BSP Mem. No. M-2013-008, at 1.

qualifies as regulatory capital."[71] The BSP defines the loss absorbency feature of financial instruments, as follows:

> Loss absorbency ensures that capital instruments are in a position to fully absorb losses before any public sector funds are injected and taxpayers are exposed to losses. Effectively, debt instruments are required to be treated similar with equity as far as absorbing losses from operations is concerned.[72]

Basel III provides two tiers to describe the structure of the capital base of banks: (i) Tier 1 Capital and (ii) Tier 2 Capital.[73] Tier 1 Capital is composed of Core Capital, which pertains to common stock, disclosed reserves, and retained earnings, in addition to non-redeemable and non-cumulative preferred stock.[74] Tier 2 Capital or Supplementary Capital, on the other hand, includes hybrid capital instruments, revaluation reserves (i.e. reserves created by the revaluation of assets), and general provisions (i.e. losses a bank may have at an as yet undetermined amount).[75] Hybrid capital instruments are those with mixed features of both debt and equity, including redeemable and cumulative preferred stock and unsecured subordinated debt.[76] This definition of capital under Basel III deviates from the ordinary accounting concept of capital as merely shareholder's equity.[77]

The loss absorbency feature makes it possible for a debt security to be treated as a Basel III–compliant Tier 1 Capital instrument, particularly when it has the following risks: (i) existence of full coupon discretion, (ii) high thresholds for likely coupon non-payment, and (iii) principal-loss absorption.[78] The existence of full coupon discretion and high thresholds for likely coupon non-payment transforms interests on the debt security into dividend-like returns, which are essentially discretionary coupons (i.e. dependent on the existence of surplus profits and the declaration of the board

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[71] *Id.*

[72] *Id.*

[73] BSP Circ. No. 781 (2013), the Basel III Implementing Guidelines on Minimum Capital Requirements; *Id.*, app. 63b/Q-46 (Risk-based Capital Adequacy Framework for the Philippine Banking System), pt. II (Qualifying Capital).

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *See infra* Part VI(B)(2) for accounting definition of shareholder's equity, which appears to be narrower than Basel III qualifying capital instruments in BSP Circ. No. 781 (2013), app. 63b/Q-46, pt. II (Qualifying Capital).

[78] CRISIL, *Rating criteria for Basel III-compliant non-equity capital*, *available at* https://www.crisil.com/Ratings/Brochureware/RR_ASSES/BASEL_III_compliant_instruments.pdf (last visited Dec. 20, 2018).

of directors). Moreover, the principal-loss absorption exposes the debt security to the risk that the face value will not be repaid in whole, a risk that is ordinarily associated with equity instruments, which are merely claims to the residual value of the issuer corporation. Again, these are manifestations of the principle of *jus residuum*.

VI. DEBT–EQUITY SCORING SYSTEM AND DEBT–EQUITY CONTINUUM

Considering the above disquisitions, this paper proposes to develop a tool that will aid in classifying Hybrid Instruments as either debt or equity based on a scoring system (the "**Debt–Equity Scoring System**"). **First**, the scoring system will survey the criteria that functionally defines pure debt and pure equity. **Second**, the system will generalize these criteria into a master list of n binary variables, $X_1, X_2, \ldots X_n$, with each variable representing either a debt feature or an equity feature. The system will assign a value of "0" for a debt feaure and "1" for an equity feature. **Third**, the system will generate the permutation of all possible values of $X_1, X_2, \ldots X_n$, from which one can infer all possible kinds of Hybrid Instruments based on the master list of relevant variables the scoring system has identified in the second step. The system will then identify the permutations that fit the profile of some commonly known Hybrid Instruments in the Philippines (i.e. perpetual bond, unsecured subordinated debt, etc.). **Fourth**, the system will obtain the sum of values in each permutation representing the proximity of a Hybrid Instrument to either pure debt or pure equity. The system will then plot these permutations along a continuum, with pure debt at the exreme left and pure equity at the extreme right, and with the permutations plotted progressively to the right according to their respective sums. From this, the system can identify Hybrid Instruments that have predominant debt or equity features based on their degree of proximity to pure debt and pure equity. To be clear, the mechanical application of the Debt–Equity Scoring System is not advised. Managers, regulators, judges, and other decision-makers should approach the Debt–Equity Classification Problem with the general principle underlying the debt–equity distinction as discussed in the previous section in mind.

First step. There are four cases decided by the CTA squarely dealing with the issue of debt–equity distinction in evaluating the validity of tax deficiency assessments: (i) *Hotel Filipinas, Inc. v. Commissioner of Internal Revenue*[79] ("**Hotel Filipinas Case**"); (ii) *Philippine Trust Co. v. Collector of Internal Revenue*[80] ("**Philippine Trust Case**"); (iii) *Boise Cascade Philippines, Inc. v. Commissioner of*

[79] CTA Case No. 1912 (Ct. of Tax Appeals Nov. 26, 1971).
[80] CTA Case No. 367 (Ct. of Tax Appeals Jan. 30, 1961).

Internal Revenue[81] ("**Boise Cascade Case**"); and (iv) *Yuchengco v. Commissioner of Internal Revenue*[82] ("**Yuchengco Case**").

In the Hotel Filipinas Case, Hotel Filipinas, Inc. ("**Hotel Filipinas**") issued shares of preferred stock, which are entitled to returns at the rate of 10% per annum, payable semi-annually or annually as the Board of Directors may determine. The shares are preferential and cumulative, whether or not in any period the amount due is covered by earnings or profits of the corporation. In case any installment of said dividend is not paid on the dividend payment date of such installment, then the amount of such installment shall subsequently be paid before any dividends shall thereafter be paid to the holders of the common stock. In the event of liquidation, dissolution, receivership, bankruptcy, or winding up of the affairs of the Corporation, voluntarily or involuntarily, except in connection with a merger or consolidation, the holders of the preferred stock shall be entitled to be paid in full, or ratably, insofar as the assets of the Corporation will permit. Hotel Filipinas paid PHP 10,000 return on the preferred shares to the preferred shareholders. It deducted the amount from its gross income. The Commissioner of Internal Revenue ("**CIR**") disallowed the deduction. The CTA sustained the CIR, holding that the amount is a dividend distribution, not an interest payment. In justifying its ruling, the CTA laid down the following:

> The distinction between interest and dividend may be briefly stated as follows:
>
> > Payments made by a corporation on its shares of stock are dividends (not deductible), but payments made on its evidence of indebtedness are interest (deductible). [...] The characteristics of an evidence of indebtedness are: a definite obligee (either by name or designation); a definite ascertainable obligation; a time of maturity, either definite or that will become definite. It may, of course, possess other features as well. [...]
> >
> > The articles of incorporation readily show that there is no provision therein that fixes a date of redemption of the preferred shares with a right to force payment in the event of default. [...]
> >
> > Redemption is obviously optional on the corporation under this stipulation and creates no obligation to pay on any fixed date[.] The

[81] CTA Case No. 2858 (Ct. of Tax Appeals Mar. 30, 1987).
[82] CTA Case No. 3429 (Ct. of Tax Appeals Jan. 6, 1988).

> most significant, if not the essential feature if a debtor and creditor as opposed to a stockholder relationship, is the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default[.][83]

In the Philippine Trust Case, Philippine Trust Co. ("**PhilTrust**") issued preferred shares of stock to the Philippine Government and paid "interest" on said shares amounting to PHP 8,109. PhilTrust deducted the amount from its gross income, which the CIR disallowed. The CTA ruled that the "interest" on the preferred shares held by the Government was actually "dividend", which is not deductible for income tax purposes. In justifying this ruling, the CTA held:

> The records do not show that the preferred shares issued by petitioner are in reality merely evidence of indebtedness. It does not appear that the so-called interest on the preferred shares is payable only out of the profits or earnings of petitioner, or that it is payable regardless of any such profits or earnings. It is not also shown whether or not there is a definite date of maturity of the preferred shares.[84]

In the Boise Cascade Case, Boise Cascade Philippines, Inc. ("**Boise PH**") obtained a loan from its parent company, Boise Cascade International ("**Boise International**"), for the purpose of re-lending portions of the loan to two distressed corporations for their rehabilitation. Boise International owns 99.24% of Boise PH. The loan from Boise International to Boise PH was documented through promissory notes with no fixed maturity date. Boise PH then recorded the interest payments on the promissory notes as interest deductions, which the CIR disallowed. The CIR issued a deficiency income tax assessment resulting from the disallowance, based on the theory that the interest payments were actually dividend distributions to Boise International. The CIR relied on the fact that Boise PH is a wholly-owned subsidiary of Boise International. The CIR also argued that the promissory notes were actually investments made by Boise International in the guise of loans to Boise PH, and that the transactions were deliberately done as part of its tax saving scheme in the form of disguised distribution of dividends designed to lessen its tax burden to the government. The CTA rejected CIR's theory, and held that the promissory notes were debt instruments, not equity instruments. In

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[83] Hotel Filipinas, Inc. v. Comm'r of Internal Revenue, CTA Case No. 1912 (Ct. of Tax Appeals Nov. 26, 1971).

[84] Philippine Trust Co. v. Comm'r of Internal Revenue, CTA Case No. 367 (Ct. of Tax Appeals Jan. 30, 1961).

justifying its ruling, it laid down the following standards for distinguishing debt and equity:

> In distinguishing whether one is payment of dividends on stock, or the payment of interest on indebtedness, this was discussed clearly in a decision of U.S. District Court of Kansas, in the case of Associated Investors, Inc. vs. U.S. [...], which we quote:
>
> [...]
>
> "What constitutes interest and what constitutes dividends are questions that have had the attention of the courts almost without limit.
>
> "In *Crawford Drug Stores v. United States*, [...], Judge Bratton speaking for the court said:
>
> > '[...] But in distinguishing between payment of dividends on stock and payment of interest on indebtedness the determining elements usually recognized for appropriate consideration are the name given to the certificates, the presence or absence of a maturity date, the source of the payments, the status of the holders in respect to being equal or inferior to that of regular corporate creditors, and the intention of the parties.' [...]
>
> [...]
>
> "In *Bowersock Mills & Power Company v. Commissioner of Internal Revenue,* [...], the Court in an opinion by Judge Murrah stated:
>
> > '. . . Although every case turns on its own facts, the courts have pointed out some of the indicia which mark the distinction between the debtor and creditor and stockholder relationship, such as the name given to the obligation; whether the holders have voting powers, and whether there is a fixed rate of interest. All of the courts agree that the most important, if not the controlling factor, is whether the obligation provides for

> certainty of payment of a fixed sum on definitely fixed dates."[85]

In the Yuchengco Case, Alfonso T. Yuchengco ("**Yuchengco**") obtained a PHP 1,890,000 loan from the Pan Malayan Management and Investment Corporation ("**PMMIC**"). Yuchengco then deducted interest expenses on the loan in his income tax returns. Yuchengco paid the loan through assignment of 11,592 shares of stock in Mico Equities, Inc. to PMMIC. The loan did not contain fixed terms for repayment, provision for payment of interest, and was without security. The CIR disallowed the interest deductions and issued tax deficiency assessment to Yuchengco. The CTA declared that the transaction was not a bona fide loan, and that the interest payments by Yuchengco to PMMIC were actually disguised dividends, taxable as income to PMMIC. In justifying its ruling, it laid down the following rules, citing American jurisprudence:

> [...] whether the shareholder gave a note or other instrument containing fixed terms for repayment, interest, etc. (loan), or whether it was a loan on open account (dividend);
>
> [...] whether the shareholder gave security for the loan (loan);
>
> [...] whether the shareholder usually repaid prior loans (loan), or whether there's a record of continual net increases in his loan account (dividend);
>
> [...] whether the shareholder was expected to have ample funds available when repayment was due (loan), or whether there were continual borrowings with no other source for repayment (dividend);
>
> [...] whether the shareholder repaid the loan with interest before its status was challenged by the Treasury (loan);
>
> [...] whether the company regularly paid a reasonable dividend as such (loan); and
>
> [...] whether the borrower was the sole or controlling shareholder (dividend).[86]

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[85] Boise Cascade Phil., Inc. v. Comm'r of Internal Revenue, CTA Case No. 2858 (Ct. of Tax Appeals Mar. 30, 1987).

[86] Yuchengco v. Comm'r of Internal Revenue, CTA Case No. 3429 (Ct. of Tax Appeals Jan. 6, 1988).

In summary, the criteria that define pure debt are as follows: (i) legally guaranteed return of amount borrowed, (ii) regular cash payments in the form of interest, (iii) stated time of maturity, (iv) first or high priority in liquidation, and (v) absence of control rights. On the other hand, the criteria that define pure equity are as follows: (i) absence of legal obligation to repay the holder at face or par value, (ii) discretionary returns on investment in the form of dividends, (iii) no term or expiration, (iv) last or low priority in liquidation, and (v) presence of control rights.

Second step. From the criteria identified in the first step, the system will generalize $n=5$ binary variables that either represent a debt or equity feature, as follows: (i) Repayment of Principal, (iii) Cashflow Stream, (iii) Term, (iv) Priority In Liquidation, and (v) Control Rights (each, a "**Security Feature**"). Thus:

Table 3. Distinction between Pure Debt and Pure Equity based on Security Features.

Security Feature	Pure Debt	Pure Equity
Repayment of Principal	Legally guaranteed return of amount borrowed	Absence of legal obligation to repay the holder at face or par value
Cashflow Stream	Regular cash payments in the form of interest	Discretionary returns on investment in the form of dividends
Term	With stated time of maturity	No term or expiration
Priority in Liquidation	First or high priority in liquidation	Last or low priority in liquidation
Control Rights	Absence of control rights	Presence of control rights

In evaluating each Hybrid Instrument, a value of "0" or "1" will be assigned for each Security Feature depending on whether it pertains to a feature of pure debt or pure equity, respectively. Hence, if a generic Hybrid Instrument does not oblige the issuer to repay the holder at face or par value of the principal, a value of "1" will be given to the Repayment of Principal feature. On the other hand, if its Cashflow Stream obligates the issuer to pay regular cash payments in the form of interest, this feature will be given a value of "0".

Third step. The total permutations of n binary variables is 2^n. With $n=5$ variables, there are 2^5 or 32 total possible permutations, which means that there are 30 generic kinds of Hybrid Instruments (i.e. excluding the 2 permutations which represent pure debt and pure equity), based on all possible variations of the Security Features in **Table 3**, as follows:

Table 4. Generic Profiles of Financial Instruments based on All Possible Variations of Security Features in Table 3.

No.	Repayment of principal	Cashflow stream	Term	Priority in liquidation	Control rights
1	0	0	0	0	0
2	0	0	0	0	1
3	0	0	0	1	0
4	0	0	1	0	0
5	0	1	0	0	0
6	1	0	0	0	0
7	0	0	0	1	1
8	0	0	1	1	0
9	0	1	1	0	0
10	1	1	0	0	0
11	0	0	1	0	1
12	0	1	0	0	1
13	1	0	0	0	1
14	0	1	0	1	0
15	1	0	0	1	0
16	1	0	1	0	0
17	1	0	0	1	0
18	0	1	1	1	0
19	1	0	1	1	0
20	1	1	0	1	0
21	0	1	1	0	1
22	0	1	0	1	1
23	1	1	1	0	0
24	1	1	0	0	1
25	1	0	0	1	1

26	0	0	1	1	1
27	0	1	1	1	1
28	1	0	1	1	1
29	1	1	0	1	1
30	1	1	1	0	1
31	1	1	1	1	0
32	1	1	1	1	1

The permutations that fit the profile of pure debt, pure equity, and some commonly known Hybrid Instruments discussed in Part II of this paper are as follows:

Instrument	Repayment of principal	Cashflow stream	Term	Priority in liquidation	Control rights
Pure debt (i.e. ordinary loan)	0	0	0	0	0
Perpetual bond	0	0	1	0	0
Unsecured subordinated debt	1	1	1	1	0
Equity-linked note	0	1	0	0	0
Fixed-rate cumulative redeemable preferred stock	0	0	0	1	1
Contingent convertible bond	1	1	0	1	0
Catastrophe bond	1	0	0	1	0
Pure equity (i.e. plain vanilla common stock)	1	1	1	1	1

Note that all Security Features of pure debt are marked "0" and that of pure equity "1". For the Hybrid Instruments in the table, the values have been filled up based on their descriptions in Part II of this paper.

Fourth step. The sum of values in each permutation or profile of instruments are as follows:

Instrument	Debt–Equity Score
Pure debt (i.e. ordinary loan)	0
Perpetual bond	1
Unsecured subordinated debt	4
Equity-linked note	1
Fixed-rate cumulative redeemable preferred stock	2
Contingent convertible bond	3
Catastrophe bond	2
Pure equity (i.e. plain vanilla common stock)	5

The instruments are then plotted along the debt–equity continuum, from lowest to highest debt–equity score, as follows:

The system is now ready to classify the Hybrid Instruments as either equity or debt. The following are predominantly debt instruments: (i) perpetual bond, (ii) equity-linked note, (iii) fixed-rate cumulative redeemable preferred stock, and (iv) catastrophe bond. On the other hand, unsecured subordinated debt is predominantly an equity instrument. One problematic classification is the contingent convertible bond, which occupies the dead center of the continuum, with a value of "3". In this case, a mechanical application of the method thus employed will not suffice.

One inherent assumption in this method is that all five Security Features (i.e. repayment of principal, cashflow stream, term, priority in liquidation, and control rights) have equal weights. However, some regulatory frameworks might give higher weights for some criteria. In foreign ownership regulation, for instance, "control rights" may rank higher than any of the other four Security Features in considering whether a Hybrid Instrument qualifies as "capital", and whether the *Anti-Dummy Law* (i.e. simulation of capital) was

violated. In such instances, a regulator, judge, or decision-maker may specify a particular Security Feature as a tie-breaker. For example, a 3/5 rating for contingent convertible bond may mean that it should still be considered a debt instrument for purpose of foreign ownership regulation, considering that it scores "0" for control rights, which is a privileged factor in this particular regulatory context. Hence, the absence of control rights in this instance (but only in this instance) might serve as a tie-breaker.

VII. CONCLUSION

This paper has examined a selection of common Hybrid Instruments currently or intended to be in circulation in the Philippine capital markets, namely: (i) perpetual bonds, (ii) unsecured subordinated debt, (iii) equity-linked notes, (iv) fixed-rate cumulative redeemable preferred stock, (v) contingent convertible bonds or debentures, and (vi) catastrophe bonds. It also identified Regulatory Arbitrage as one of the motives for issuing Hybrid Instruments, through which firms take economic advantage of the differential treatment of debt and equity in various regulatory contexts. This includes exploiting differential tax rates of interest and dividends, and trading gain on debt and equity instruments, which we have compared across different taxpayers, maturities, and modes of exchange. It reviewed some rules made by judges on debt–equity distinction and has narrowed the functional elements of debt and equity down to five Security Features, namely: (i) Repayment of Principal, (ii) Cashflow Stream, (iii) Term, (iv) Priority in Liquidation, and (v) Control Rights. From this, 30 generic kinds of Hybrid Instruments based on all possible variations of these five features were identified. This paper also proposed a general principle underlying the debt–equity distinction based on the concept of the equity-holder as "bearer of the residual risk. Finally, a scoring system was developed for measuring the proximity of hybrid securities to either debt or equity.

In the next decade, more developments are anticipated in the Philippine Hybrid Instruments market, which may give rise to more Debt–Equity Classification Problems, either in the administrative or judicial level. The Bureau of Internal Revenue or the Supreme Court are also expected to come up with a more comprehensive and explicit debt–equity distinction guidelines for purposes of taxation. We hope the analytical framework laid down in this paper may serve as a starting point for formalizing such guidelines or rules. We also hope that this framework can jumpstart discussions on the Debt–Equity Classification Problem in other regulatory contexts which privilege one form of security over another.

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