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Trends in Financial Market Innovations: The Role of Taxes

By

Jakob Bundgaard, Michael Tell, Steffen Bonde Jensen, Katja Dyppel Weber, Petter Bjerksund, Gunnar Stensland, Ingebjørg Vamråk, Axel Hilling & Anders Vilhelmsson

Foreword

Table of Contents

Part I

Chapter 1 – Debt-flavoured Equity Instruments in International Tax Law[1]

Jakob Bundgaard[2]

Abstract

Debt and equity can be structured to resemble one another through hybrid financial instruments. In this contribution the emphasis is on the tax issues related to debt-flavoured equity instruments in international tax law. This most important example of such instruments is preference shares.

The article introduces the financial construction of preference shares and presents the rationale behind the existence hereof. As the main contribution the article presents an analysis of the international tax law aspects of preference shares, which includes a comparative overview, emphasizing the domestic tax classification and treatment in the United States, Germany, and Denmark. Moreover, the classification and treatment according to EU tax directives and double tax treaties is presented.

1. Introduction

Within the fascinating world of financial engineering debt and equity can be structured to resemble one another. In the contribution the emphasis is on the tax issues related to debt-flavoured equity instruments in international tax law. This most important example of such instruments is preference shares. Shares may be designed to include one or several features which are characteristics typically found in debt. Such shares are commonly referred to as preference shares or preferred shares ("vorzugsanteile" in German)[3]. Preferred shares can sometimes be structured as functional equivalents to debt[4].

Preference shares were first issued by Maryland road and canal companies in the US in the 1830's. Since then the practice spread to US railroads in the 1840s and 1850s to finance construction projects. The railroad companies were financially distressed. These shares allowed fixed dividends[5].

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[1] The article has been published in Intertax, Wolters Kluwer, Law & Business, Volume 42, Issue 6&7, 2014.

[2] Managing director, PhD, CORIT Advisory LLP, Honorary professor, Aarhus University.

[3] See e.g. *Tirole*: The Theory of Corporate Finance, 2006, p. 76. *Coyle*: Hybrid Financial Instruments, 2002, p. 82 describes preferred stock as not being equity.

[4] Cf. *Edgar*: The Income tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50. In fact certain issues of preference shares have been described as having modelled as convertible bonds, cf. Riskworx: The Anglo Platinum Preferences Shares Modelled as Convertible Bonds, 2004, regarding a 204 South African preference shares issuance.

[5] See *Evans*: The Early History of Preferred Stock in the United States, American Economic Review, 1929 and *Laurent*. Securities that to the deal: The decision to issues preference shares by UK firms, 2006, p. 2.

Today preference shares are commonly used in public and private transactions and it may be argued that such instruments are not perceived to be nearly as exotic as other types of hybrid financial instruments[6].

2. Financial Construction

While the investor investing in preference shares is a member of the issuing company, the security will normally carry with it a number of "quasi-debt" benefits[7]. As a result although preferred equity is risk capital, the investor is ensured a certain cut of distributed profits.

Preference shares may have a variety of different attributes[8]. In general preference shares allow a preferable treatment of the holder with respect to economic rights while being granted only few or none decision rights in the company. The holder may be granted a favorable position with respect to receiving dividends or liquidation proceeds. The dividends may even be fixed. Dividend payments may be cumulative or non-cumulative (cumulative or non-cumulative preference shares). The shares may be mandatorily redeemable by the issuing company whereby the shareholder may demand redemption from the issuing company or the company may be allowed to demand a repurchase of shares (mandatory redeemable preference shares) after a number of years or maybe the shares are irredeemable. Convertible shares may also be convertible into other classes of share capital or even into debt (convertible shares)[9]. Moreover, preference shares may exclude voting rights (non-voting preference shares) or include limited or full voting rights.

As mentioned preference shares can be conventional, cumulative, participating, redeemable and convertible[10]. Cumulative preferred shares entitle their holder to a fixed rate of dividend, and if any dividend is unpaid, the arrears of dividend remain payable and accumulate. The preferred shareholders must receive their arrears of dividend before any ordinary dividend can be paid to other shareholders. Participating preference shares have extra dividend rights and allow holders in addition to their fixed dividend to also participate in the company's surplus. Redeemable preferred stocks are shares that

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[6] A recent example is the issuance of preference shares by Goldman Sachs with Warren Buffet as the investor. In *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11, preferred shares are stated to be the most common form of hybrid equity. Preference shares are found to be the second most commonly used type of hybrid securities, cf. Deutsche Bank: The Theory and Practice of Corporate Debt Structure, 2006, p. 37. See moreover *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 244, stating that the importance of preference shares for banks should still rise in order to prospectively become compliant with Basel III and hereby particularly with the additional Tier 1 capital requirements.

[7] See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11.

[8] See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11, *Laurent*, id, p. 5, *Hey* in Hybrid Financing, 1993, p. 104, *Coyle*: Hybrid Financial Instruments, 2002, p. 82 et seq., *Helminen*: The International Tax law Concept of Dividend, 2010, p. 198 et seq., *Lamon* in DFI 2002, 58, *Ferran*: Company Law and Corporate Finance, 1999, p. 53 and *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 244 et seq.

[9] *Nørgaard & Werlauff*: Vedtægter og aktionæroverenskomster, 1995, p. 170.

[10] *Coyle*: Hybrid Financial Instruments, 2002, p. 83.

either will be redeemed at a specified future date, or could be redeemed at a specified date, at the option of either the company or the shareholders. Convertible preferred stocks give their holder the right to convert their stock into ordinary shares of the company, at a specified future date or between specified future dates, at a specified rate of conversion.

Depending on the attributes of the preference shares, they can be viewed along a spectrum from quasi-debt to quasi-equity instruments[11]. Accordingly depending on the attributes of the preference share in question there may be only a slight difference between PPL's and e.g. cumulative non-voting preference shares[12]. However, empirical studies suggest that preference shares are primarily considered an alternative to ordinary shares[13].

3. The Financial Decision to Issue and Invest in Preference Shares

From the perspective of the issuer it may be more attractive to raise money by equity, rather than debt issue since issuance of preference shares is likely to be cheaper in terms of coupon and will normally have a positive impact on the issuer's gearing ratio[14]. The case for preference shares has also been described as situations where companies need equity investors with entrepreneurial risk, but where the companies do not want to give the investors control in the company[15].

Traditionally the case for preference shares is that they are issued by financially distressed companies. Existing capital structure theories concentrate on the attributes of equity and debt and do not in general consider hybrid financial instruments[16]. *Laurent* has analysed whether the existing capital structure theories relating to straight debt and equity can explain the use of preference shares and convertible debt in the UK. *Laurent* tested the theories of taxation, bankruptcy, agency costs and pecking order. One result was that some support could be expressed to the theory, according to which the firms with high volatility of earnings uses less debt in their capital structure if preference shares are assumed to be substitutes for equity and convertible debt as substitutes for debt. In addition the analysis supported other findings stating that taxation plays a minor role in the financing decision. However, *Laurent* was unable to rationalise the use of hybrid financial instruments based on capital structure theories based on the evidence provided by the empirical investigation[17].

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[11] See *Laurent*, id, p. 5.
[12] Cf. also *Helminen*: The International Tax law Concept of Dividend, 2010, p. 199, emphasizing that from an economic perspective, there is not much reason for distinguishing between the tax treatment of debt and preferred non-voting redeemable shares.
[13] See *Laurent*, id, p. 27.
[14] See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 13.
[15] See *Helminen*: The International Tax law Concept of Dividend, 2010, p. 199.
[16] See *Laurent*: Capital Structure Decision: The Use of Preference Shares and Convertible Debt in the UK, 2001, p. 3 et seq.
[17] Id., p. 36.

According to *Bärsch* the economic functions of preference shares are *that* they allow the investor an effective way to exit its investment, *that* the liquidity outflow is more cash-flow oriented from the issuer's perspective and *that* convertible preference shares may be attractive for investors who could seek a classification as equity for financial accounting purposes[18].

Given the fact that preference shares are essentially equity type instruments such instruments are often regulated by domestic company laws which is rarely the case for hybrid debt instruments.

As an example preference shares ore often used in the venture capital industry where multiple categories of investors are involved[19]. The investor in preferred equity is able to preserve the ability to participate in future gains through appropriate conversion rights while, in the meantime, maintaining a fixed income and some degree of protection through preferential rights on a return of capital[20].

Preferred instruments are also seen in the private equity industry where the so-called carried interest in fact allows the holder a preferred return on investment[21]. Carried interest is a business standard regarding the remuneration of partners/managers in private equity funds and venture capital funds. Such funds are most commonly structured via partnership structures either directly or through personal holding companies of the partners. Carried interest payments result in a distribution of the economic return on the investment which does not match the invested capital. Typically a 20% yield is obtained according to the carried interest mechanism if a hurdle rate of IRR 8% has been met at an initial investment of 1-2%. Since carried interest mechanisms often refer to participation in partnerships the following shall not address this any further.

Well-known US examples of preference shares are PERCS (Preferred Equity Redemption Cumulative Stock), PRIDES (Preferred Redeemable Increased Dividend Equity Securities) and DECS (Dividend Enhanced Convertible Stock). PERCS are preferred shares which offer limited upside participation with the underlying stock and mandatorily convert into common stock at maturity[22]. PRIDES are preferred shares which mandatorily convert into common shares at maturity.

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[18] *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 245.
[19] See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 12.
[20] See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 12.
[21] See *Lambart Meier*: The Carried Interest Controversy: The U.S. and U.K. Reform Movements of 2007, TNI 2008, April 21, 2008, p. 255 et seq., *Aron-Dine*: »An Analysis of the Carried Interest Controversy«, Center on Budget and Policy Priorities, 2007, *Sanchirico*: Tax Tax Advantage to Paying Private Equity Fund managers with Profit Shares: What Is It? Why Is It Bad?, The University of Chicago Law Review, 2008, p. 1072 et seq, and *Anziger & Jekerle* in IStR 2008: Entwicklungen in der besteuerung des Carried Interest in Deutschland, Grossbritianien und den USA – Denkanstösse aus der neuen Welt?, p. 821 et seq., *Okamoto & Brennan*: Measuring the Tax Subsidy in Private Equity and Hedge fund Compansation, Drexel University College of Law, Legal Studies Research Paper Series 2008-W-01.
[22] See *Coxe* in Nelken (ed.): Handbook of Hybrid Instruments, 2000, p. 31 et seq.

Other examples include Redeemable Preference Shares (RPS) and Mandatory Redeemable Preference Shares (MRPS) are instruments often used in several private transactions[23].

4. Tax Treatment of Preference shares in Domestic Tax Law

4.1. Comparative overview

For accounting purposes according to IAS 32 ordinary preference shares are considered equity instruments. However, preferred shares that pay a fixed dividend and that have mandatory redemption feature at a future date are classified as liabilities because the substance is that they are a contractual obligation to deliver cash[24].

Most countries seem to classify preference shares as equity for tax purposes[25]. In general terms the tax treatment of debt seems to be favoured over equity. Consequently, the need for reclassifying equity as debt for tax law purposes is not as great as the need for reclassifying debt as equity[26]. Such a need is primarily seen where the scope of participation exemption regimes or foreign tax credit regimes are at stake.

Certain countries have introduces specific rules targeted on preference shares. This includes Canada which has introduced such rules in 1987 with the purposes of taxing dividends from preferred shares[27]. Similarly such rules were introduced in Australia in 1987. The legislation has the intent of preventing the substitution of tax-free dividends for taxable interest income[28]. Australia has been widely known for the possibilities to issue certain types of redeemable preference shares (RPS) which allow deductibility of dividend payments. Thus, particular redeemable preference shares can fulfill the debt test according to Australian tax law[29]. This has i.a. been confirmed in a case before the Federal Court, Noza Holdings Pty Ltd v Commissioner of Taxation [2011] FCA 46.

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[23] Typical legal terms of MRPS are 10 years maturity, no voting rights, right to a fixed preferred dividend based on nominal value of MRPS issues, annual distribution of preferred dividend, preferential right to the reimbursement and a liquidation preference to the MRPS holder.

[24] See IAS 32 and *Humphreys*: Tax Deductible Equity: The Quest for the holy grail, Tax Forum, 2006, p. 26.

[25] See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 200 and *Helminen*: The Dividend Concept in International tax Law, 1999, p. 313 regarding US law, p. 313 regarding German law, p. 314 regarding Swedish and Finnish law. See *Lamon* in DFI 2002, p. 59 regarding Belgian Law. *Edgar*: The Income tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 49 et seq. regarding Canadian law. See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 246 et seq. and p. 253. regarding Australian law, p. 248 and 254 regarding German law, p. 250 and 255 regarding Italian law, p. 252 and 256 regarding Dutch law.

[26] See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 200.

[27] See *Edgar*: The Income Tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50.

[28] See *Edgar*: The Income Tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50.

[29] See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p.246 et seq.

UK case law has concluded that a preference share carrying a 5% interest dependent on the profits of the corporation was a creditor relationship similar to a debenture holder[30]. Specific legislation has recently been enacted in the UK regarding deemed loan relationships and disguised interest. Moreover, specific legislation has been introduced in order to deal with non-participating or fixed rate redeemable preference shares. The consequence of the rules is that, unless certain exceptions are met, any shares accounted for as a liability will be taxed as though they are a liability and the return will be taxed within the loan relationship regime[31]. Here it is seen that the accounting treatment will be decisive.

In Dutch law preference shares and the yield thereon is generally respected for tax purposes in so far the civil law classification is in place[32]. However, two recent appeals court cases suggest that in the view of some, a reclassification of equity into debt may be justified under certain circumstances. The first case concerned redeemable preference shares in an Australian company. The characteristics of the redeemable preference shares were that (i) they annually pay a cumulative preferred dividend of 8%, increasing to 12% of the amount contributed on the redeemable preference shares, (ii) they have basically no voting rights and (iii) they will be redeemed within ten years[33]. The participation exemption is applied to the income derived from the redeemable preference shares. As a consequence, although the payments on the redeemable preference shares were still deductible under Australian tax law, they were no longer taxed at the level of the Dutch taxpayer. The court case revolved around two questions, namely (i) should the redeemable preference shares be reclassified as debt and (ii) should the application of the participation exemption be denied on the basis of the abuse of law doctrine.

The Lower Court ruled that the redeemable preference shares were in fact a loan because they had a fixed maturity of less than 50 years, a fixed interest rate which was not dependent on the profit of the Australian company and the redeemable preference shares did not have voting rights. On appeal, however, the Court of Appeal stated that the redeemable preference shares were comparable to preference shares issued by a Dutch company to which the participation exemption would have applied[34]. Therefore, the redeemable preference shares could be considered as participation within the meaning of the participation exemption provisions and as a consequence, the income was exempt. As a consequence, the use of the redeemable preference shares cannot be regarded as violating the aim and purpose of the participation exemption, and the abuse of law doctrine therefore does not apply. According to *van Gelder & Niels*, the advocate-general is quite right in dismissing the abuse of law

[30] See Uk High Court 1954, Inland Revenue Commissioners v. Pullmann Car Co. Ltd. (1954) 12 TC 1159.
[31] See CFM45510 – Deemed loan relationships: shares accounted for as liabilities.
[32] See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 143) and *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 252.
[33] See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 143).
[34] AC Amsterdam (Gerechtshof Amsterdam), 7 June 2012, 11/00174, VN 2012/40.11.

argument, and if that argument were to be followed by the Dutch Supreme Court it would be clear that the Dutch abuse of law doctrine as such does not restrict application of the participation exemption in cases where a hybrid finance instrument is used[35]. On February 7 2014 the Hoge Raad upheld the decision. Hoge Raad rejected the tax authorities' position than an instrument that qualifies as equity from a legal perspective as debt for purposes of the application of the participation exemption. The Hoge Raad opined that the main legal characteristic of equity is its risk profile. In an instrument satisfies this main characteristic and otherwise qualifies as equity from a legal perspective, then the presence of other debt-like features do not result in a reclassification as debt for tax purposes. In addition the Hoge Raad stated that the application of the participation exemption does not depend on whether the subsidiary is able to deduct the dividends paid or on the accounting treatment at the level of the parent company or the subsidiary[36].

In the other case regarding a bank-refinancing arrangement the Court of Appeal decided that the case at hand was within the sham transaction doctrine, as the banks designed an equity contribution, but in fact intended to grant a loan[37]. According to Dutch commentary both rulings are somewhat surprising, and when now followed by the Dutch Supreme Court, might have a severe impact on the application of the participation exemption to hybrid finance instruments[38].

Since the date of effect in 2008 of Spanish GAAP Spanish law has allowed for the issuance of non-voting shares which must be accounted for debt.

4.2. US Federal Tax Law

Preferred shares are commonly known in the US. As a starting point preference shares in their most basic form are classified as equity for tax purposes[39]. However, preferred stock is a security where the blurred line between debt and equity is often tested[40]. The type of preferred stock and how it is structured will determine its status as debt or equity.

Redeemable preference shares may in certain cases face debt classification. Mandatory redemption features seem to particularly increase the likelihood of debt classification.

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[35] See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 143).
[36] See *Gelen & Oudemans*: Netherlands Tax Alert, 14 February 2014: Supreme court confirms treatment of hybrid instruments for participation exemption purposes.
[37] See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 144).
[38] See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 144).
[39] See *Hammer* in DFI 1999, p. 340. It seems that venture capital backed firms are financed through convertible preferred stock, cf. *Gilson & Schizer*: Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 230. The authors explain this fact by pointing at the more favorable tax treatment for incentive compensation paid to the entrepreneur and other portfolio company employees by way of transmuting ordinary income into deferred capital gain.
[40] See *Hammer* in DFI 1999, p. 340 and *Haun*: Hybride Finanzierungsinstrumente im deutschen und US-amerikanishen Steuerrecht, 1996, p. 195 et seq.

One example of preferred stock that has been treated as debt is Monthly Income Preferred Stock (MIPS). In 1993 the first MIPS (Monthly Income Preferred Shares/Securities)[41] were introduced in the US Market and the first transaction undertaken by Texaco Corporation. The net effect of the transaction was that Texaco was able to deduct interest on a subordinated loan and at the same time the instruments were not shown as debt on the balance sheet[42]. A MIPS transaction provides a borrower with an interest expense deduction while avoiding reporting the borrowing for financial accounting purposes. Generally a pass through entity is set up by the borrower. The pass-through entity then issues equity interests (the MIPS) that have a debt-like return[43]. The proceeds from the sale of the MIPS are lent to the borrower, thereby allowing the borrower to take an interest expense deduction. Commonly, the borrower and the pass-through entity are consolidated for financial accounting purposes, which results in the elimination of the debt and allows the issuer to treat the MIPS as a minority equity interest in a subsidiary resulting in an increase of its capital. If the entity is consolidated with the issuer and the issuer for accounting purposes, then the debt is ignored and the issuer is treated as having issued some form of preferred interest to the public[44].The IRS issued a Technical Advice Memorandum in which it found a MIPS transaction to be debt[45].Notice 94-47 was the Treasury Departments administrative response to the increased use of MIPS. The Treasury hereby posted "off-limits" signs around certain transactions[46]. The IRS also analysed MIPS during an audit of a taxpayer (apparently Enron) in 1998, which resulted in the issuance of Technical Advice Memorandum 199910046. The TAM held that the issuer can deduct interest on a MIPS-like instrument.

In a recent case the US Tax Court determined that a complex and tax driven investment structure involving preferred shares should be treated as a loan for Federal income tax purposes[47]. The conclusion was reached after thoroughly reviewing the debt-equity factors in detail.

4.3. German Tax law

Preference shares are commonly known and widely used in Germany[48]. Preference shares issued according to German company law (§§ 12 Abs. 1 S. 2, 139-141 AktG) are considered regular equity

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[41] MIPS is just the trademark name from one Investment Bank. Other names for similar products or progeny products are: TOPrS, QUIPS, QUIDS, TECONS, ACES, ENHANCED PRIDES, TRUPS (being exchangeable MIPS).
[42] *Humphreys* in PLI/Tax, 2006, p. 379 et seq (p. 398), *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 1030 et seq., *Connors & Woll* in PLI/Tax, 2002, p. 16 et seq., *Freeman, Stevens & Hollender* in 734 PLI/Tax, 2006, p. 861 et seq. (p. 866-873), *Hammer* in DFI 1999, p. 340.
[43] MIPS has been found in many variations and are generally known as trust preferred securities. Thus, reverse MIPS, Debt MIPS, Convertible and Exchangeable MIPS are found.
[44] See *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 1030.
[45] TAM 199910046, the same result in reached by *Humphreys* id. and *Garlock*: The Taxation of Debt Instruments, 2006, p. 1031 et seq.
[46] *Humphreys*., at p. 402.
[47] T.C. Memo. 2012-135 *Hewlett-Pachard Company and consolidated Subsidiaries*.
[48] See *Jacob* in Cahiers, 2000, p. 316, *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p.152 et seq., and *Bowitz & Heinrichs* in Maisto (ed.): Taxation of intercompany Dividends under tax Treaties and EU Law, 2012, p. 567.

instruments and the preference shareholders are considered members of the corporation. The shares carry membership rights with the exception of voting rights. Issuance of preference shares with voting rights is possible but rare[49]. Preference shares are issued with a cumulative preference with respect to dividends.

Preference shares are generally respected as equity in German tax law and there are no specific provision governing the taxation of preference shares[50]. The generally applicable principles regarding equity classification of genussrechte also applies to the classification of preference shares[51]. As a consequence the remuneration on preference shares is non-tax deductible for the purposes of German corporate income tax and local business tax. Remuneration on preference shares qualify as dividend according to German tax treaties due to the autonomous definition and the reference to domestic tax classification in Germany[52]. No cases of reclassification into debt for domestic tax purposes have been reported[53]. Reclassification, however, cannot, be ruled out with respect to such preference instruments which resemble profit participating debt more than equity.

4.4. Danish Tax law

Preference shares can be issued according to Danish company law. Early issuances of preference shares included non-voting shares with a fixed cumulative dividend payment and shares without right to liquidation proceeds if the total repayment would exceed par value[54]. A recent Danish company law reform was based on the reasoning that financing decisions are not a simple choice between debt and shares but a wide range of different instruments where rights and obligations for the issuing company and its investors are accommodated to the needs and risk position of the parties[55]. Consequently, according to the expert panel company law should not create obstacles for the desirable financing and investment decision which the parties agree. Based on this reasoning non-voting shares were re-introduced in Danish law in 2010 and the wide possibility to issue preference shares in a variety of forms was reiterated.

Preference shares which are actually issued in accordance with company law procedures should be accepted for Danish tax law purposes and treated as other shares for tax law purposes. Preference

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[49] See *Bowitz & Heinrichs* in Maisto (ed.): Taxation of intercompany Dividends under tax Treaties and EU Law, 2012, p. 567.
[50] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p.152, *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 248 et seq. and *Hey* in Hybrid Financing, 1993, p. 104: "*Preferred dividends are afforded dividend treatment like any other ordinary dividend under national law for purposes of tax treaties and the EC parent-Subsidiary Directive".*
[51] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 152.
[52] *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 249.
[53] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p.153-154 and *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 313.
[54] See *Berning*: Finansieringsret, 1977, p. 162 et seq.
[55] See Betænkning 1498, 2009, p. 175.

shares have been widely used in practice to ensure generational changes and used to fulfill formal ownership criteria (eg. the 10% participation exemption threshold)[56].

In general preference shares are recognised in Danish tax law as being shares and the remuneration as dividends. Case law supports a conclusion according to which the substance over form doctrine does not apply to transactions which are governed by company law. This conclusion should even apply to non-voting cumulative preference shares and mandatory redeemable preference shares. However, the question cannot be answered in general, since an actual assessment of the preference shares in question should be made.

The debt/equity distinction has drawn only little attention in Danish tax law. When Danish companies are involved as issuers of securities the investment is qualified according to formal rules in Danish company law.

In general there are very few examples of tax law reclassification of formal equity into debt or even reclassification from dividends to interest payments. Shares issued by Danish companies are in general defined by way of reference to the formal company law registration system. If a share is registered as such with the Danish Business Authority it should be qualified in the same way for tax law purposes[57]. Once the registration is made the courts have been more dismissive regarding the reclassification of companies which have been formally registered even on the basis of wrong information[58]. It is generally accepted in theory and practice that the notion of share capital should be qualified in the same way for company law and tax law purposes. As a result hereof tax payers have been denied tax deduction regarding losses on shares if the shares were not registered as such for company law purposes.

In TfS 1990.240 LSR formal equity was disregarded. A Danish subsidiary of a Swiss parent company in February 1985 subscribed shares through a capital increase in a US sister company. The cash contribution was financed by postponing an already planned construction activity. Simultaneously with the share subscription the company and its parent company entered a contract granting the parent company a right and an obligation to acquire the shares to the price initially paid. The shares were acquired in 1986 by the parent company. The National Tax Tribunal found that the funds were in fact a loan to the parent company, based on the reasoning that the funds of the Danish subsidiary as a consequence of the parent company's influence over the Danish company were used to the benefit of the financially distressed US company. As a consequence the Danish company was taxed on the basis of

[56] See e.g. SKM 2003.134 LR (dividend preference), SKM 2005.549 LR (dividend preference), SKM 2008.360 SR, SKM 2008.600 SR and SKM 2010.631 SR (interest bearing share without economics rights).
[57] See TfS 1996, 603 V and TfS 1984, 189 Ø, not allowing the tax payer a loss deduction on shares acquired on the basis of a capital increase which was not formally registered.
[58] See LSRM 1942, 15, LSRM 1947, 2, and TfS 1989, 68 H.

an arm's length interest according to SL § 4.[59]. Albeit the decision concerns the question of taxation of deemed interest income and the arm's length principles the reality is that the decision expresses a disregard of formal equity into a loan.

Besides the case presented above, the closest we get to a reclassification of equity seem to be the High Court decision in TfS 2003.889 H. The decision was however later reversed by the Supreme Court[60]. The High Court denied interest deductibility in a financing transaction aiming at utilising losses carried forward on the basis of a substance over form line of thinking. The decision was based on a close relationship between obtaining a loan, an increase of capital and a subsequent capital reduction. Based on this fact pattern the court did not find that the company has substantiated a real right to dispose over the funds advanced by the loan and that a loss making company did not have a real right to dispose over the funds advanced as equity. The High Court found that the funds from the loan were predetermined to be used to on-lend to a group company. Moreover, the court found that the loans were not giving rise to a real risk for the companies involved and that the transactions did not serve a business purpose. In total the loan was disregarded for tax law purposes. As it is seen the disregard of company law formalities only occurs indirectly as a consequence of the disregard of the loan. To reach this result the High Court must have found that the actual capital increase of the other company was not carried out or in fact carried by another company irrespective of the fact the the company in question did subscribe for shares in the capital increase process. As already stated supra the Surpeme Court reversed the decision based on the reasoning that the procedure engaged in by the companies was a legitimate planning technique based on an explicit statement regarding financial loss making companies in the then applicable LL § 15, par. 7(3).

The aftermath of the Finwill-decision analysed supra is that there is only very limited support – if any at all – in existing case law in favour of reclassification of a formally existing equity investment. Most recently the same conclusion was implicitly uphelp by the Danish Eastern High court in SKM 2012.534 Ø. One remaining question, however, is whether the conclusion is also generally applicable with respect to reclassification of dividend payments. A crucial question is whether a declared dividend for company law purposes can be classified differently for tax law purposes. To answer this it should be assesses whether the notion of a dividend for tax law purposes is tied up to the company law notion of a dividend and whether declared dividends can be said to exist only as a consequence of the company law legislation. The tax law notion of dividends in LL § 16 A is broader than declared dividends for company

[59] See for commentary *Michelsen* in R&R 1991 SM, p. 144 et seq, questioning whether the Tax Tribunal would have reached the same conclusion if there was no agreement to sell shares to the parent company, even though that the parent company could force such a sale through.
[60] See for commentary *Michelsen* in R&R 2004 SM, p. 2. et seq., *Severin Hansen* in TfS 2004, 88, *Guldmand Hansen* in SR-Skat 2004, p. 50 et seq., and *Bundgaard* & *Møllin Ottosen* in ET 2008, p. 59 et seq.

law purposes. Thus, the tax law concept of dividends includes disguised dividends. This fact does not however imply that the notion of a dividend for tax law purposes can be understood in a narrower sense than to cover at least all declared dividends[61].

Based on case law it seems possible at least in certain cases to reclassify dividend payments into other categories of income for tax law purposes.

Reclassification of dividend payments to interest payments is seen in TfS 1985.324 LR regarding preference shares. The National Assessment Board was asked to confirm whether payments received from a newly formed Irish financing company would qualify for exemption in Denmark according to Article 6 of the Denmark-Ireland Double Tax Convention. An Irish company wanted to increase its activities in Denmark and a part of these considerations involved the formation of a new Irish company with a share capital of 8.000.100 USD. The share capital should be divided into shares of a nominal value of 100 USD. The remaining 8.000.000 USD should be preference shares, without voting right. The preference shares should be sold to another Danish company. The Irish company would then on lend the money to the Irish parent company with the intent to purchase an aeroplane, which should then be leased out. At the same time the Irish parent company guaranteed to the holders of the preference shares (including the Danish holders) that the preference shares during the term of the leasing contract, could be sold to a third party at par value plus dividends not yet paid out. The Irish financing company could anticipate a fixed income from the loan to the Irish parent company and consequently could pay out fixed dividends to its shareholders. The terms were known by the holders of the preference shares in advance.

The National Assessment Board decided that the payments should not be considered dividends covered by the Denmark-Ireland Double Taxation Convention. It was not directly stated that the income was instead interest income, but this it generally thought to be the case[62]. The Board emphazised the following to support the decision:

- that the preference shares did not have a right to vote,
- that the dividend could be calculated in advance,
- that the shares could be sold at par value,
- that accrued dividends should be paid if the shares were sold,
- that the paid in capital was determined for a loan to the parent company.

[61] See in general on classification of dividends *Byskov* in TfS 1999, 193.
[62] See SpO 1985, p. 135.

The decision does not provide any general guidelines regarding the classification of hybrid financial instruments for domestic Danish tax law. It should moreover be noted that the binding ruling is more than 25 years old and does not arise from a Danish Court. Moreover, the case concerns the interpretation of a tax treaty and is based on the actual facts of the case in question. Further it may have played a role that Article 6 of the then applicable Denmark-Ireland treaty should be interpreted in a way that both countries did not tax dividends and that the method if double taxation relief according to Article 23 was the exemption method. Thus, as a result of the treaty the dividends would not be taxed at all[63].

Recently the question was more generally raised in a ruling in SKM 2007.199 SR. The Tax Board was asked to decide whether dividends paid prior to a subsequent sale of shares could be reclassified to cash payment for the sale of shares. The dividends would be tax exempt in the hands of the recipient according to SEL § 13, par. 1(2). The tax payer referred to the Finwill-decision. The Tax Board, however, found that irrespective of the Finwill-decision it is possible to classify dividends different from the company law classification, but did not find any reason to do so in the actual case[64].

In SKM 2010.141 SR dividends were reclassified into salary income. The dividends replaced previous salary payments to the tax payer in question and moreover the answer was given as a specific requestion by the tax payer who asked the Tax Board to confirm that this was the correct tax classification for Danish tax purposes.

There is no basis to reclassify dividends on the basis that the dividend is deductible at the level of the paying entity. This is confirmed by the specific provision in SEL § 13(1)(2) disallowing participation exemption if the paying company can deduct the payment.

5. EU Corporate Tax Law Directives

The PSD will be the natural starting point when considering the taxation of income from preference shares in European Union tax law. The IRD should on the other hand not be applicable to yield from preference shares since preference shares do not fulfil the autonomous interest test definition of the IRD[65].

Preference shares that form part of the subsidiary's capital is similar to any other shares. The directive does not describe the term "capital" as used in Article 3(1) further, but the directive does not distinguish between different types of capital. Moreover, the term "capital" is understood to include not only actual

[63] See *Michelsen* in R&R 1991 SM 144.
[64] *Bjørn* criticizes the decision in SR-Skat 2007, p. 84 et seq. A similar result is however reached in SKM 2007, 488 SR regarding dividend payments after a tax free merger. The Tax Board presupposes a possibility of reclassifying dividends to cash payments in the transactions.
[65] See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 249 from the perspective of German law.

shareholdings, but also hidden equity capital. As stated by Thömmes, the commentary to Article 10 of the OECD Model may be used as an aid for interpretive purposes[66]. However, further refinements resulting from the future practice of the ECJ cannot be ruled out[67].

The general opinion among legal commentary seems to be that the benefits of the PSD should also as a starting point be granted to dividends from preference shares[68]. As a possible limitation to this *Helminen* has stated that the application of the directive should not be required if the economic nature of a payment is not a distribution of profits but rather a payment of interest[69]. From the perspective of the state of residence of the subsidiary there is hardly an incentive to reclassify the dividend payments into interest payments. This might change from the perspective of the state of residence of the parent company.

Whether or not this is allowed for the Member State of the parent company depends on whether or not the underlying transaction can be considered abusive in the sense laid down in Article 1(2) of the directive. As I have analysed elsewhere the conclusion is that Member States cannot reduce the scope of the PSD by way of reclassification of the yield from HFIs, including preference shares[70]. Supportive of such a broad interpretation of the PSD is that the directive seems to include yield from equity-like debt instruments to fall within the ambit of the PSD. Based on this the directive should even more so include under its scope dividend payments from preference shares.

It is my opinion that the scope of the PSD cannot be reduced on the basis of deductibility of the yield in the Member State of the paying company. Since it is not expected that ECJ will apply a teleological interpretation to reduce the scope of directives, a literal interpretation should prevail in this context. A reduction of the scope of the directive should be based on specific provisions in the directive allowing this. The only option is to apply the fraud and abuse provision in Article 1(2) of the PSD. However, tax arbitrage does not as a general rule constitute an abusive practice. Contrary to this *Helminen* concludes the following in this respect: *"…in the case of wholly artificial tax avoidance arrangements where there are no business reasons for the use of preferred shares instead of debt, the benefits do not have to be made available…"*[71]*.*Based on the available interpretive sources I see no legal basis to include a business motive test in the PSD.

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[66] See *Thömmes* in EC Corporate tax Law, Binder 1, 1992, p. 35, para. 35 to Article 3 of the PSD. It is stated the Commission itself referred to the relevant section of the commentary (para. 15 to Article 10 of the OECD Model) when asked for an interpretation of the term "capital" during the Councils discussions.
[67] See *Thömmes* in EC Corporate tax Law, Binder 1, 1992, p. 35, para. 35 to Article 3 of the PSD.
[68] *Helminen*: The International tax Law Concept of Dividend, 2010, p. 201.
[69] Id.
[70] See *Bundgaard* in ET 2010/10, pp. 442-456 and ET 2010/11, pp. 490-500.
[71] Id, p. 202.

It is concluded that the scope of the PSD cannot be reduced on the basis of deductibility in the Member State of the paying company. Since it is not expected that ECJ will apply a teleological interpretation to reduce the scope of directives a literal interpretation should prevail. A reduction of the scope of the directive should be based on specific provisions in the directive allowing this. The only option is to apply the fraud and abuse provision in Article 1(2) of the PSD. However, it is concluded that tax arbitrage does not as a general rule constitute an abusive practice. The most recent proposal of the Commission for an amendment of the PSD Article 4 seems to confirm such an interpretation of the currently applicable directive. According to the proposal participating exemption should not be granted with respect to dividend payments which are deductible in the state of the paying company ("*refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary of the parent company*")[72]. According to *van Gelder & Niels* an amendment of the PSD that requires Member States to deny participation exemption may be in conflict with the principle of sovereignty in tax matters if a member state does not want to tax in that situation[73].

6. Double Tax Treaties

In the context of double tax treaties, the yield on hybrid financial instruments may classify as dividend payments under Article 10, as interest payment under Article 11 or as other income under Article 21 in double tax treaties agreed on the basis of the OECD Model Tax Convention[74]. Moreover, Article 7 and Article 13 of treaties based on the OECD Model may be of relevance. For the sake of simplicity, only the dividend provision and the interest provision are analysed in the following with respect to preference shares. The demarcation is of great importance since the taxing right under the treaties differs depending on the type of income.

The term "capital" as used in Article 10(2)(a) of the OECD Model should also include preference shares since capital is understood as it is understood in company law[75].

With respect to companies (i.e. non-transparent companies according to Article 3(1)(b)) it may be assumed that the relevant treaty provisions are Article 10 and Article 11 of the OECD model[76]. The

[72] See COM(2013) 814 final. Apparently the proposal does not apply to dividend payments which are deductible at a lower tier than the immediate subsidiary.
[73] See *van Gelder & Niels* in DFI 2013, p. 147.
[74] See in general *Köhler* in Piltz/Schaumburg (eds.): International Unternehmensfinanzierung, 2006, 137 et seq., *Six*: Hybride Finanzierung im Internationalen Steuerrecht am beispiel von Genussrechten, 2007, p. 94 et seq., and *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 393 et seq.
[75] See para. 15 to Article 10 of the OECD Commentary.
[76] If the issuing company on the other hand is a transparent entity the relevant treaty provisions may be Article 7 or Article 11 of the OECD model. See to this effect *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 136.

classification of yield on preference shares for tax treaty purposes relies on the generally applicable tests, ie. the corporate test and the debt claim test[77].

The concept of "dividends" is defined in Article 10(3) of the OECD Model Tax Convention as:

> *"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."[78].*

The OECD Commentaries are silent on the question of whether or not income from a share can be treated under Article 11. As analysed by *Pijl* the question is whether a "share" can ever leave the ambit of Article 10 and whether the dividend definition would exclude a shares if the share is so thoroughly stripped that is does not participate in profits? *Pijl* here refers to preference shares that do not participate in profits and are materially equal to debt claims[79]. The author finds that Article 10(3) should be interpreted in a manner whereby the phrase "participating in profits" also applies to shares. As a consequence being a share does not automatically mean that the yield of the share qualifies as dividends for tax treaty purposes[80]. The author concludes that "participating in profits" refers back to the previously mentioned titles in the dividend Article, which includes shares. Shares must participate in profits to make the income qualify under Article 10. A practical comment to this is that most preference shares seem to actually participate in the profits of the company since economic preference is the main feature of preference shares. On the other hand *Pijl* finds that it would be jumping to conclusions if it is claimed that such income would not fall under Article 10, as the instrument could qualify as "other corporate rights", subject to the same domestic tax treatment of the income. When the income from this type of preference shares is treated like a dividend in the state of the distributing company, a tax treaty accepts this under Article 10[81]. When domestic law does not treat the income from preference shares as participating in the profits of the company as dividends, such preference shares do not fall under the scope of Article 10, and the question arises whether Article 11 can be a substitute[82]. *Pijl* answers this

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[77] See *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 136.
[78] See in general regarding the interpretation of this Article, e.g. *Baker*: Double Taxation Conventions, 2003, p. 10-1 et seq., *Vogel*: On Double Taxation Conventions, 1997, p. 646 et seq., *Vogel/Lehner*: DBA Doppelbesteuerungsabkommen Kommentar, 2008, p. 917 et seq., *Helminen*: The Dividend Concept in International Tax Law, 1999, passim, *Lang*. Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 85 et seq., *Schuch* in Eigenkapital. 2005, p. 217 et seq., *Giuliani* in Bulletin 2002, p. 11 et seq., *Fehér* in Conflicts of Qualification in Tax Treaty Law, Burgstaller/Haslinger (Eds.), 2007, p. 227 et seq. (p. 234 et seq.), *Avery Jones et al*. in World Tax Journal 2009, p. 5 et seq.
[79] See *Pijl* in BIT 2011, p. 493-494.
[80] See *Pijl* in BIT 2011, p. 493-494.
[81] See *Pijl* in BIT 2011, p. 493-494.
[82] See *Pijl* in BIT 2011, p. 493-494.

question negatively as the term "debt-claim" in Article 11 should be taken in its legal meaning[83]. As a consequence, even if a preference shares have overwhelming debt claim chacteristics, it cannot fall under Article 11. I agree with this interpretation.

This interpretation may not be in line with the interpretation of *Lang*, according to which mandatorily redeemable preferred stocks may be classified as debt for tax treaty purposes if the redemption price is fixed and does not depend on the income of the economic situation of the issuing company and the ongoing participation in profits include participation of the hidden reserves of the issuing company[84].

Generally dividends from preference shares qualify as dividends according to Article 10 of the OECD Model[85]. Preference shares qualify as corporate rights for tax treaty purposes[86]. The scope of Article 10 includes dividends as well as liquidation proceeds which may arise from preference shares. This also includes non-voting cumulative preference shares and redeemable preferred stocks. The absence of voting rights seems to be of less relevance[87]. Investors with provisions on mandatory redemption share the risk of the company, but only until redemption. From a risk perspective the investment is therefore comparable to the risk of a debt investment[88]. In liquidation, the investment is similar to other share investments and not debt investments. According to *Helminen*, the only situation where a preferred share may not qualify as a corporate right is when it contains both a mandatory redemption provision that requires redemption within a relatively short period of time and a provision that grants liquidation preference[89].

Applying the debt claim test to preference shares this test should not be met since no debt claim exists[90].

Certain emissions of instruments in the Anglo American market appear like preference shares but require a detailed analysis of the true content and nature of the instrument in question in order to determine whether the yield of such instrument should be considered dividends or interest payments. Yield from instruments which include the term preference share in the name should not necessarily be

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[83] See *Pijl* in BIT 2011, p. 493-494.
[84] *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 138.
[85] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 408, *Schuch* in Bertl et al. (eds.): Eigenkapital, 2004, p. 230 et seq., *Haun*: Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steurrecht, 1996, p. 198 et seq.
[86] See *Vogel*, p. 653, stating that restriction of the control rights, as in the case of non-voting preference shares, therefore, do not result in disqualification for the purposes of Article 10(3). Privileges and prejudices, even in respect of property rights, which lead to distinctions being made between various categories of shares, are likewise irrelevant, unless any lack of one of the essential elements of the term "share" laid down in Article 10(3) disqualifies a holder from claiming a share in the company's profits or a share in its liquidation proceeds.
[87] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 408. See *Haun*: Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steurrecht, 1996, p. 198 et seq. with respect to Adjustable Rate Preferred Stocks (ARPS).
[88] See *Helminen*: The Dividend Concept in International tax Law, 1999, p. 318.
[89] Id., p. 318.
[90] See e.g. *Pijl* in BIT 2011, p. 494.

classified as dividends if the true economic nature of the instrument would lead to a different classification[91].

Classification conflicts may arise if the state of residence treats the income from preferred shares as interest payments whereas the source state treats the same yield as dividends. The state of residence is not obliged to respect the source state classification unless it agrees that the income originates from corporate rights[92]. In practice classification conflicts are rare with respect to income from preferred shares[93]. This conclusion is supported by the fact that only a few countries reclassify preference shares and the yield thereon for domestic tax purposes.

[91] See *Schuch* in Bertl et al. (eds.): Eigenkapital, 2004, p. 231.
[92] See *Helminen*: The Dividend Concept in International tax Law, 1999, p. 318.
[93] See *Helminen*: The Dividend Concept in International tax Law, 1999, p. 319.

Chapter 2 – Tax and Crowdfunding in Denmark[94]

Michael Tell[95] ***& Steffen Bonde Jensen***[96]

Abstract

Crowdfunding is progressing worldwide and in Denmark too. The chapter explains the tax consequences for crowdfunding in Denmark. It is analyzed how investee and investor are taxed under four different crowdfunding models, the donation model, the reward model, the debt model and the equity model. Finally, the chapter presents several proposals from the Danish Government to give incentives to use crowdfunding as a financing source.

1. Introduction

Crowdfunding is emerging worldwide. This new and alternative funding method is inter alia used in start-ups, political campaigns, commercial projects and non-profit projects. In countries such as Italy, United Kingdom, the US and Germany start-ups have had great success in raising capital through crowdfunding[97].

Crowdfunding in Denmark is emerging as well, even though legislative barriers limit the use of some crowdfunding models. These legislative barriers include prospect rules, banking legislation, suppliers of payment services, securities traders, administer of alternative investment funds, money laundering and terror financing, which were addressed in a memorandum issued by the Financial Services Authorities.[98] The memorandum does not touch upon tax consequences. Despite these barriers, some crowdfunding associations and platforms have been established including Danish Crowdfunding Association and Booomerang.dk.

The purpose of this article is to analyse the tax consequences of crowdfunding in Denmark through the different crowdfunding models.

2. Crowdfunding Models

Crowdfunding is a collective term for a variety of alternative financing models where a project or company is financed by a large pool of investors (crowd)[99]. Crowdfunding is an alternative to more

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[94] The article is pending to be published in Derivatives & Financial Instruments.
[95] Ph.D., Assistant Professor at CBS and Senior Associate at CORIT Advisory.
[96] Associate at CORIT Advisory P/S.
[97] See Crowdfunding für Startups – der Jahresrückblick 2013, Crowdfunding—Deutschland, January 16, 2014.
[98] See memorandum issued the 18th of November 2013 "Orientering om samspillet mellem alternative finansiering og den finansielle regulering".
[99] See Crowd-funding: transforming customers into investors through innovative service platforms, Andrea Ordanini, Lucia Miceli and Marta Pizzetti & A. Parasuraman, Emerald Group Publishing Limited, Journal of Service Management, Vol. 22 No. 4, 2011, pp. 444-445.

conventional funding methods such as bank loans, business angels and capital through venture capital funds[100]. Often, a large amount of investors invest, while each investor contributes only with a relatively small amount.

There are four main models of crowdfunding:

1. Donation Model
2. Reward Model
3. Debt Model
4. Equity Model

The models differ in levels of commitment of both the investors and investee. Further, there are many ways of composing the contract within the different crowdfunding models. In the following sections, the tax consequences applicable to the four models are analysed.

3. Donation Model

The donation model involves an element of charity or generosity. The investor simply donates money to the project or company without any financial return or other tangible benefits in return. In other words, the investee is granted a donation with no strings attached. However, the donation might offer the investors the opportunity to get connected with the investee or use the donation for advertising purposes.

3.1 Taxation of the Investor

The investor donates money without a claim for a return. As a main rule, such a cost is not deductible for the investor. However, exceptions do apply.

Firstly, the donation might be considered a deductible marketing expenditure within the scope of Art. 8(1) in the Tax Assessment Act (TAA)[101]. The investor must then substantiate that the donation is used for advertising purposes, that the donation amount is reasonable and that the advertisement sufficiently targets an indefinite group of customers or potential customers[102].

Secondly, the donation is deductible if the investee is recognized as a charity by the Danish tax authority or in an EU/EEA country. If so, a Danish investor can deduct donations up to a total of 14,800 DKK per year (2014). A list of approved organizations is published online by the tax authorities[103]. In practice,

[100] Ibid, p. 448 and 452.
[101] See also SKM2011.85.SR.
[102] See SKM2004.262.LR.
[103] See the list at: https://www.skat.dk/SKAT.aspx?oID=2061734.

only non-profit charities are approved meaning that commercial crowdfunding projects do not fulfill this criterion.

Whether a non-resident investor can deduct the donation depends on the tax treatment in the country of residence. However, if the investor has a permanent establishment in Denmark he may be able to deduct the donation in accordance with the two above mentioned exceptions.

3.2 Taxation of the Investee

The investee receiving a donation is taxable subject to Art. 4 of the State Tax Act (STA) with a few exceptions.

Firstly donations given to individuals (non-incorporated) from certain family members are not taxed. Instead a gift duty is levied on the donation in certain situations:

- Donations from grandparents, step-grandparents, parents, stepparents and children are not levied with a gift duty up to 59,800 DKK (2014). Donations exceeding this amount are levied a gift duty of 15 % of the excess amount.
- Donations from stepchildren and grandchildren are not levied with a gift duty up to 59,800 DKK (2014). Donations exceeding this amount are levied a gift duty of 36.25 % of the excess amount.
- Donations from in-laws are not levied with a gift duty up to 20,900 DKK (2014). Donations exceeding this amount are levied a gift duty of 15 % of the excess amount.

Further donations to certain charity organizations, associations and independent foundations are tax exempt. This does not include limited liability companies or individuals. Most commercial crowdfunding projects do not fulfill this criterion while some non-profit organization may fulfill this criterion.

4. Reward Model

The reward model is rather similar to the donation model and the models are often used simultaneously. In the reward model the investor is rewarded for the investment with a tangible benefit (asset) - typically the first specimen of the product developed by the investee. Differentiated rewards are often used to attract larger investments. Typically, there is a significant time lapse between the investment and the receiving of the reward. If the product is never developed, the investor is often paid back the investment – if possible. The reward model therefore has many similarities with the purchase of goods or services.

4.1 Taxation of the Investor

The investor invests in the project or company in return for receiving a reward. The investment is considered a non-deductible acquisition cost for the investor and the received reward is tax exempt. Further a resale of the reward is also tax exempt. However, two exceptions apply.

Firstly, if the investor uses the reward (asset) in course of business, the investor might be able to write-off depreciations on the asset in accordance with the Depreciation Act. Assets with a purchase price less than 12,600 DKK (2014) can be written off in the purchase year. Assets exceeding 12,600 DKK can be written off according to the declining balance method or on a linear basis depending on the asset.

Secondly, if the investor invests with the purpose of making profit on the resale of the reward (asset), the resale of the asset will be taxed and the investment (acquisition cost) can be deducted from the sales price. Further, it should be noted that a resale of an asset in all cases could result in taxation of recaptured depreciations in accordance with the Depreciation Act.

Thirdly, if the investor never receives the reward due to bankruptcy the investor can deduct the loss on the claim. However, in situations where an investor is controlling the investee, or the investor and investee are group companies, the investor cannot deduct the loss. Further, individuals obtaining a yearly net capital loss of less than 2,000 DKK cannot deduct the loss (de minimis rule).

It should be noted that if the investment far exceeds the value of the reward, the investment may be wholly or partly considered a donation. In practice, the tax authorities will only challenge the reward model if the investment clearly differs from the market value of the reward[104]. Nonetheless, if the investment is considered a hybrid, the donation part of the investment is treated as described in section 3.1.

Lastly, if the reward constitutes an option for the investor to buy an asset at a fixed price at a specific time in the future, capital gains may be taxed in the period between the investment and the exercise date. However, it depends on the specific circumstances and must be analyzed in each specific case.

Whether a non-resident investor can deduct investment depends on the tax treatment in the country of resident. However, if the investor has a permanent establishment in Denmark the above mentioned tax consequences apply.

4.2 Taxation of the Investee

The investee receives payment for the sale of the reward (good or service). Therefore, the investee is taxed on the profit or can deduct a loss depending on whether the sales price exceeds the cost of the good or service.

[104] See the Administrative Legal Guidelines ("Juridisk Vejledning"), section C.A.6.1.2.1.

As mentioned in section 4.1 it should be noted that if the investment far exceeds the value of the reward, the investment may be wholly or partly considered a donation. If so, the donation part of the investment is treated as described in section 3.2.

Lastly, if the reward constitutes an option for the investor to buy an asset at a fixed price at a specific time in the future, capital gains may be taxed in the period between the investment and the exercise date. However, it depends on the specific circumstances and must be analyzed in each specific case.

5. Debt Model

The debt model is a lending arrangement between the investors (crowd) and the investee. The debt model is also known as peer-to-peer lending. The loan is to be repaid and the investor receives a financial return. Usually, the investor receives higher interests than available on bank deposits, while the investee pays lower interest rates than on conventional funding - if even available. The advantage of a debt model compared to equity model is that the investor is exposed to less risk (default risk) while the ownership of investee remains the same.

In Denmark specific banking and investment rules are impeded on intermediaries and the investee using the debt model. This includes intermediary (facilitators) operating an internet platform where investors and investees can meet. These rules include approval to exercise banking or investment activity, solvency requirements, supervision by the Danish Financial Supervisory Authorities etc. However, it seems that there might be political willingness to amend these legislative constraints in order to facilitate crowdfunding.

5.1 Taxation of the Investor

The investor lends money to the investee. The mere disbursement of the loan is not deductible nor is the repayment of the loan taxable. However, the return on the loan is taxable. Interests are taxed up to 42 % for individuals and 24,5 % for companies.[105] Capital gains on claims are also taxed 24,5 % for companies, while individuals with yearly net capital gain less than 2,000 DKK are not taxed according to the de minimis rule.[106] Capital gains above 2,000 are taxed up to 42 %.

Whether a foreign investor is taxed on the return on the loan depends on the tax laws in the residence state. A foreign investor is only taxed in Denmark (withholding tax) if the investor and investee are group companies, which seldom is the case in crowdfunding.

[105] Cf. Art. 4 of the STL.
[106] Cf. the Capital Gains Tax Act (CGTA).

The investor might incur a capital loss on the claim if the investee is not able to repay the loan. In such cases the investor can as a main rule deduct the loss.[107] However, some exceptions do apply. For individuals a loss on claims are not deductible in the following situations (non-exhaustive):

- The total yearly net capital loss is less than 2,000 DKK (de minimis rule)
- Claims against controlled companies
- Claims against family
- Claims where the taxation of interest or capital gains are restricted due to a tax treaty

For companies a loss on claims are not deductible in the following situations:

- Claims against group companies
- Claims where the taxation of interest or capital gains are restricted due to a tax treaty

A non-resident investor cannot deduct such a loss in Demark unless the claim is allocated to a Danish permanent establishment. Whether the non-resident investor cannot deduct such a loss in the residence state depends on the tax laws in the resident state.

5.2 Taxation of the Investee

The investee is not taxable of the disbursement of the loan and cannot deduct the repayment of the loan. However, the return (interest and capital losses) on the loan can as a main rule be deducted as described in the following.

Interest is deductible for both individuals and companies according to art. 6 of the STA. However, companies may incur a restriction on the deductibility (i) if the net financial costs exceeds 21.3 Mio. DKK or (ii) the investor is a group company and the investee is thinly capitalized.[108]

Capital losses on debt are only deductible for individuals if the loan is not issued in Danish kroner (DKK) and the losses exceed 2,000 DKK in the income year.[109] Capital losses on debt incurred by companies are deductible.[110] However, companies may also incur a restriction on the deductibility on the capital losses (i) if the net financial costs exceeds 21.3 Mio. DKK or (ii) the investor is a group company and the investee is thinly capitalized.[111]

If the investee is not able to repay the loan, the investee will incur a capital gain on the debt. For individuals, capital gains are tax exempt, but certain exemptions apply if the loan is written down below market value, the loan was to be repaid at an amount lower than the initial loan amount or the loan is

[107] Ibid.
[108] See Michael Tell, Interest Limitation Rules – an Analysis of the Danish Legislation, Nordic Tax Journal, 2013.
[109] Cf. Art. 23 of the CGTA.
[110] Cf. Art. 6 of the CGTA.
[111] See Michael Tell, Interest Limitation Rules – an Analysis of the Danish Legislation, Nordic Tax Journal, 2013.

not issued in Danish kroner (DKK). For companies such a capital gain is taxable as a main rule. However, capital gains are tax exempt if the loan is written down to the market value in a collective arrangement with creditors or a compulsory settlement or the investor and investee are group companies.

6. Equity Model

In the equity model the investor invests in the investee in return for shares (ownership) in the investee. The equity model will therefore often result in many shareholders (crowd) with small shareholdings. The equity model is often more complex than the other crowdfunding models due to the risk and change in ownership. However, the equity model also has the biggest upside because the residual return accrues the equity owners.

In Denmark both the investee and the intermediary (facilitator) have to comply with non-tax legislative rules. For example the investee must comply with different prospectus rules depending on the volume of the public offering ranging from limited prospectus rules on public offerings up to 1 Mio. EURO and full range prospectus rules on public offerings exceeding 5 Mio. EURO.[112] Further, facilitator of the investment may be considered an investment company. If so, the facilitator must comply with the same requirements as banks, such as solvency requirements and be supervised by the Danish Financial Supervisory Authority. However, it seems that there may be political willingness to amend the legislative constraints on equity crowdfunding.

6.1 Taxation of the Investor

The investor invests in the investee in return for shares in the investee. The mere disbursement of the investment is not deductible for the investor and the mere receiving of the shares is tax exempt. The resale of the shares and received dividends are as a main rule taxable.

For individuals, capital gains on shares and dividends are taxable at a rate of 27 % up to 49,200 DKK (2014) and 42 % for exceeding amount. Further, capital losses on shares are deductible – however, for a deduction of capital losses on listed shares it is conditional that the purchase was initially reported to SKAT.

For companies, capital gains on shares are tax exempt if the company owns at least 10 % of the share capital (listed or unlisted) or owns less than 10 % of the share capital in an unlisted company. On the other hand, capital losses are not deductible under such circumstances. Dividends are tax exempt if the investor owns at least 10 % of the share capital. In all other circumstances dividends are taxable. The typical crowdfunding investor would own less than 10 % of the share capital and therefore be tax

[112] Statutory order, number 643 of June 19 2012 about prospectus for securities traded on a regulated market, and public offerings of securities over 5,000,000 EURO.

exempt on capital gains, but taxable on dividends. Dividends are taxable at a rate of 24.5 % declining to 22 % in 2016.

A non-resident investor is not taxed in Denmark on capital gains on shares, but will be taxed on received dividends (withholding tax). Dividends are taxed with 27 %, which can be reduced to 15 % or even lower, depending on the agreement between Denmark and the resident state of the investor. However, for company investors dividends are tax exempt if the investor owns at least 10 % of the share capital and the taxation were to be reduced according to an agreement between Denmark and the resident state of the investor or the Parent-/Subsidiary Directive.

6.2 Taxation of the Investee

The investee receives an investment in exchange for issuing shares. The invested capital is tax exempt for the investee and the issuing of shares is not deductible. If the investee distributes dividends, such distributions are not deductible.

7. Tax Policy Considerations

Access to capital is essential for all companies, but even more essential for start-up companies. The 8th of May 2014, the Danish Government presented its Growth Plan called "Denmark Fully Out of the Crisis – Growing Enterprises". The growth plan contains 89 initiatives among these two initiatives related to equity crowdfunding.

First, the government proposes to introduce a deduction from 2016 of up to 650,000 DKK for equity investments carried out by individuals subscribing shares in small companies. This would truly encourage equity crowdfunding of Danish start-up companies and we welcome such an initiative. It should also be noted that the government is awaiting further analysis of whether such a deduction system is compatible with EU state aid legislation.

Second, the government proposes to reduce the taxation of dividends paid from unlisted companies. The government proposes to tax only 70 % of the dividends paid from unlisted companies to company shareholder owning less than 10 % of the share capital. If enacted the effective taxation of such dividends would be around 16 % from 2015 and onwards.

While we welcome such initiative without a reduction of some of the non-tax legal barriers, equity crowdfunding still has poor conditions in Denmark. The government still needs to discuss different solutions with the rest of the parliament, and a bill has recently been proposed, which calls on the parliament to force the government by the end of 2014 to identifying the legal obstacles for crowdfunding and make appropriate legislative proposals to ensure that crowdfunding can be realized in Denmark. Hopefully, the debate and draft bill will generate new legislative basis for crowdfunding,

thereby making crowdfunding more attractive as an alternative financing source. Changes are especially needed in relation to non-tax barriers (prospectus, solvency, banking rules etc.) to stimulate the use of the debt and equity model.

8. Summary

Crowdfunding is emerging worldwide and in Denmark as well. This new and alternative funding method is inter alia used in start-ups, political campaigns, commercial projects and non-profit projects. In more countries start-ups have had success with crowdfunding, but in Denmark several legislative barriers limit the use of crowdfunding.

There are four main crowdfunding models – donation based model, reward based model, debt based model and equity based model. The four crowdfunding models all have different tax consequences for the investor and the investee. The Danish tax consequences are summarized in the following table:

	Investor	**Investee**
Donation model	Main rule: No deduction. Exc. 1: Donations related to the business of the investor. Exc. 2: Donations to an approved charity. Up to 14,800 DKK per year (2014) are deductible.	Main rule: Taxable. Exc.: Donations received from family are tax exempt, but may be levied with a gift duty.
Reward model	Main rule: No deduction for the investment and no tax on the reward received. No tax on resale of the reward. Exc. 1: Investor using the reward (asset) in the business might be able to write-off depreciations on the asset. If so a resale of the asset will result in taxation of recaptured depreciations. Exc. 2: Investors investing with the purpose of making profit on the resale of	Tax/deduction on the net gain/loss.

	the reward. Capital gains on the resale are taxable and capital losses can be deducted.	
	No deduction for the disbursement and no taxation of the repayment.	No taxation on the disbursement and no deduction for the repayment.
	Interest and capital gains are taxable, while capital losses are deductible.	Companies: Interest and capital losses are deductible, while capital gains are taxable.
Debt model	Exceptions do apply as described in section 2.3.1.	Individuals: Interest is deductible. Capital losses are not deductible, while capital gains are tax exempt.
		Exceptions do apply as described in section 2.3.2
	No deduction for the disbursement and no taxation of the received shares.	The investment received is tax exempt and the issuing of shares is not deductible.
Equity model	However received dividends and capital gains on the subsequent sale of shares are taxable, while capital losses are deductible.	Distribution of dividends is not deductible.
	Exceptions do apply for companies as described in section 2.4.1.	

The government has recently presented a growth plan that meets some of the needs in relation to equity crowdfunding. Two initiatives have been suggested including a deduction for the investor of up to 650,000 DKK for equity investments carried out by individuals subscribing shares in small companies. The second initiative includes a limited taxation on dividends paid from unlisted companies owning less than 10 % of the share capital. However further changes are needed in relation to prospect and banking rules etc. to make crowdfunding more attractive in Denmark.

Chapter 3 – Corporate Bonds in Denmark

Michael Tell[113]

1. Introduction

Corporate financing is the choice between capital generated by the corporation and capital from external investors. External investors can either be lenders (debt) or shareholders (equity). However, since the financial crisis shook the markets in 2007-08, financing opportunities through the classical means of financing have decreased. As a result, corporations have to think in alternative ways in order to obtain the needed capital for their investments at the right price.

In Denmark debt financing has historically been dominated by mortgages secured in real estate and bank debt. However, due to the financial crisis and stricter bank regulations focus has shifted towards corporate bonds. Consequently this has also led NASDAQ OMX to introduce the *First North Bond Market* in December 2012. The aim is to build a market for corporate bonds in Denmark as a market based alternative to traditional debt financing, similar to those already existing in Norway, Germany, France, the United Kingdom and the United States. Some large Danish corporations have historically used foreign corporate bonds markets. The new regulatory framework from 2014 may contribute to a Danish based corporate bond market that will benefit all Danish corporations and investors as new alternative financing opportunities arises.[114]

The purpose of this article is to present the regulatory changes in Denmark in relation to corporate bonds. The purpose is further to analyse the tax consequences of issuing bonds in both a direct issue of bonds and through securitization. Lastly, the purpose is to analyse the tax consequences of using a trustee when issuing corporate bonds.

2. Corporate Bonds

The corporate bond market is one of the largest over-the-counter (OTC) financial markets in the world.[115] Corporate bonds constitute an alternative, or a supplement, to bank and mortgage loans secured in real estate, and can be defined as a debt security issued by a corporation. By issuing corporate bonds companies can obtain a diversified capital structure with fewer constrains on the business and become less dependent on banks.

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[113] Ph.D., Assistant Professor at CBS and Senior Associate at CORIT Advisory.
[114] See *Khang and King*: Capital market access and corporate loan structure, Applied Economics 2015, Vol. 47, No. 4, pp. 374-397 on correlation between access to capital and corporate loan structure.
[115] See *Asquith*: The market for borrowing corporate bonds, Journal of Financial Economics, Vol. 107, Issue 1, pp. 155-182.

The prerequisite for a successful issuing of corporate bonds is, of course, a reasonable price and consistency with risk, e.g. coherence between the risk and the expected return (effective interest rate) from the corporate bond.[116] The terms of the corporate bonds are agreed on in each term sheet connected to the issue and therefore vary from issue to issue depending on the market and the issuing corporation. Corporate bonds usually have a medium-term range between one and seven years, and involve fewer covenants than bank loans.[117] However, no market standard or template exists in Denmark, even though Danish corporations have issued corporate bonds since the 80's.[118]

A corporate bond basically consists of a nominal interest rate and is traded at a certain market price. The basis for the interest rate is the risk-free interest rate (i.e. a government bond with the same maturity), plus a margin that reflects the issuer's creditworthiness and the maturity of the bond (risk premium). A low creditworthiness or a long maturity leads to higher interest rates, due to the higher risk.[119] Further, an investor will also take into account the liquidity of the market and the currency in which the corporate bond is denominated, and this therefore also affects the market price of the corporate bond. In summary, the overall return of the corporate bond is the effective interest rate, which depends on the nominal interest rate, and the market price of the corporate bond (gains and losses).

The issuing of corporate bonds would usually require an ongoing rating from an international credit rating agency, which is an expensive process (due diligence etc.). A credit rating is important due to a large number of investors that are only allowed to invest in bonds with an "official" credit rating. The initial and ongoing credit rating will affect the effective interest rate through the market price. An issuer of corporate bonds is therefore less dependent on banks, but more dependent on international credit rating agencies.[120] Analysis also shows that corporate bond borrowing costs are related to the bond's credit rating, but also loan size, and the lender's inventory.[121]

Corporate bonds will often be listed on a stock exchange, historically in the United States, Luxembourg or the United Kingdom. However, most of the trading is not done on the stock exchange, but instead over-the-counter by various investment banks.[122] Nevertheless, the listing is still important in order to

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[116] For valuation of corporate bonds, see *Mortensen*: Essays on Pricing of Corporate Bonds and Credit Derivatives, Samfundslitteratur 2005, pp. 11-66 and *Jarrow, Li and Liu*: Reduced-form valuation of callable corporate bonds: Theory and evidence, Journal of Financial Economics, Vol. 95, issue 2, pp. 227-248.
[117] See *Galbo and Rosenbaum*: Revision & Regnskabsvæsen, no.5, 2013, p. 36. and *Kielland and Schaumburg-Möller*: Udstedelse af virksomhedsobligationer, Erhvervsjuridisk Tidsskrift 2012, ET 2012, 19.
[118] See *Kielland and Schaumburg-Möller*: Udstedelse af virksomhedsobligationer, Erhvervsjuridisk Tidsskrift 2012, ET 2012, 19.
[119] See *Kielland and Schaumburg-Möller*: Udstedelse af virksomhedsobligationer, Erhvervsjuridisk Tidsskrift 2012, ET 2012, 19.
[120] See *Kielland and Schaumburg-Möller*: Udstedelse af virksomhedsobligationer, Erhvervsjuridisk Tidsskrift 2012, ET 2012, 19.
[121] See *Asquith*: The market for borrowing corporate bonds, Journal of Financial Economics, Vol. 107, Issue 1, pp. 155-182.
[122] See See *Asquith*: The market for borrowing corporate bonds, Journal of Financial Economics, Vol. 107, Issue 1, pp. 155-182.

make the corporate bond attractive for institutional investors, who are only allowed to invest in listed securities.[123]

The market for corporate bonds has been modest in Denmark and only some of the larger Danish corporations such as AP Moller-Maersk, Carlsberg, DFDS, Dong Energy, ISS, TDC, Vestas and Welltec have issued corporate bonds. However, the market is growing in Europe and maybe the market in Denmark will also grow significantly after the regulatory issues and limitations have been eased in 2014.

3. Regulatory Issues

The main issue in relation to issuing corporate bonds has been the requirement to be authorised as a financial institution (bank) set forth by the Financial Services Authority (FSA). However, in 2012 the FSA eased their interpretation of the regulation and issued new guidelines on corporate bonds, specifically affecting issues to a selected few investors (less than 150 investors) with an investment of at least 100.000 EUR per bond.[124]

The new interpretation eased the process of issuing bonds and was made in connection with a committee working on a special report on corporate bonds. The main output of the report was recommendations on how to create a well-functioning corporate bond market to benefit all Danish corporations.

3.1 Report on Corporate Bonds

In November 2012 the committee presented the final report on *Corporate Bonds as a Source of Financing for Small and Midsized Corporations*.[125] The committee concluded that the financial crisis and the tightening of the credit policy in banks had permanently reduced small and midsized corporations' access to capital. As a result the committee recommended establishing a market for corporate bonds in Denmark. The overall aim is to create a proper sized market, enabling spread and liquidity in the market. The general recommendation for establishing such a market was followed by five specific recommendations:

1) Establishing the legal framework for a trustee
2) Establishing the legal framework for securitization
3) Establishing an effective process of issuing corporate bonds

[123] See *Kielland and Schaumburg-Möller*: Udstedelse af virksomhedsobligationer, Erhvervsjuridisk Tidsskrift 2012, ET 2012, 19.
[124] See guidelines from FSA, dated July 4 2012.
[125] See Report from "Udvalget om erhvervsobligationer som finansieringskilde for små og mellemstore virksomheder", dated November 2012.

4) The Ministry of Business and Growth contributing on market based terms to a well-functioning market of corporate bonds
5) The Ministry of Business and Growth's initiatives only target market failures and are phased out when the financial situation is normalized

The committee found that a well-functioning corporate bond market would benefit small, midsized and large corporations. Large corporations were already able to issue corporate bonds, but the introduction of a legal framework for a trustee would benefit both the issuing corporation and investors. Corporate bonds are, due to the high fixed cost for both the issuing corporation and investors (rating etc.), not attractive for small and midsized corporations. However, the establishment of securitization through banks etc. made it possible to issue bonds secured in a large pool of commercial loans to small and midsized corporations (SMEs) to the benefit of SMEs and investors. The report laid the groundwork for the new legislation on corporate bonds enacted with bill L 46 2013-14.

3.2 Legislation

Bill L 46 2013-14 was adopted in December 2013 to stimulate a corporate bonds market. The most significant changes were the introduction of a trustee model in Denmark and the possibility of securitization from January 1, 2014.

3.2.1 Trustee model

A trustee is usually a financial institution, such as a commercial bank or trust company that is given powers by a bond issuer to enforce the terms of a bond issue. A trustee is to protect the interests of the bondholders, acts on behalf of the bondholders if the issuer violates the bond terms and responsible for the registration, transfer and payment of bonds. Bill L 46 enables the issuing corporation to appoint one or more trustees to represent the investors (bondholders) by adopted a new chapter to the Danish Securities Act on trustees and corporate bonds.[126] However, certain requirements must be met to use the trustee model in Denmark.

To use the trustee model the trustee must be registered by the FSA and on each specific issuing of corporate bonds, which are marketed to Danish investors, issued by a Danish corporation or in other ways connected to Denmark.[127] The trustee must also appear in the terms of the issued bonds or in an associated agreement.[128] Furthermore the trustee must be a limited liability corporation resident in

[126] See Sec. 4 c.
[127] See Sec. 4 a and 4 b.
[128] See Sec. 4 c.

Denmark, the EU, a country with an agreement with the EU on financial matters, Switzerland, Australia, Canada, Hong Kong, Japan, South Korea, New Zealand, Singapore, Taiwan or the United States.[129]

The trustee represents all the investors.[130] The terms of the representation must be stated in the terms of the bonds or an associated agreement. Such terms can state that the trustee:[131]

1. Must enforce and execute bondholders' claims against the issuer as stated in the terms
2. Must manage the bondholders' assets as stated in the terms
3. Can take legal action on behalf of the bondholders in relation to the bonds
4. Represents the bondholders if the issuer goes bankrupt or is reconstructed
5. Can convene bondholder meetings

In all cases the trustee must act in the best interest of the bondholders.[132] Furthermore, the bondholders can, according to the terms, be prevented from autonomously enforcing rights that are transferred to the trustee (no-action clause).[133] Lastly, it should be noted that the trustee agreement is also legally enforceable in regard to the bondholders' creditors, bankruptcy estate and subsequent owners (investors) of the bonds.[134]

3.2.2 Securitization

Securitization is a financial practice of pooling various types of assets for example commercial loans and selling the consolidated loans to various investors. Usually a large portfolio of assets such as commercial loans are pooled and transferred to a Special Purpose Vehicle (SPV), which will then issue bonds on the basic of the transferred commercial loans. The basic idea of securitization is that for example a bank can by selling commercial loans meet capital requirements, lower risk or obtain earlier "repayment" in the form of selling the commercial loans. Transferring a large pool of commercial loans can be resource intensive, due to legal restraints such as denunciation. However bill L 46 adopts a register based securitization model in the Danish Financial Business Act, which enables bonds to be issued on the basis of a large pool of commercial loans.[135] The register model is inspired by the model used in Germany and works in two steps: First a sale of commercial loans from a bank to a special purpose vehicle (SPV)[136] i.e. the SPV is registered as the owner of the loans in a refinancing register. Second, the SPV issues bonds

[129] See Sec. 4 b.
[130] Sec. 4 d.
[131] See Sec. 4 d, Para. 4.
[132] See Sec. 4 d, Para. 2.
[133] See Sec. 4, Para. 5.
[134] See Sec. 4 c.
[135] See Sec. 152 n.
[136] As defined in sec. 5, Para. 1, no. 25.

secured in the registered commercial loans. Securitization can also be made through another bank, insurance corporations, pension fund etc. instead of a SPV.

The register model improves the balance sheets of banks, due to the sale of the loans, and unlike a true-sale securitization can sell the loans without the administrative burden of denunciation. The introduction of the register model in Denmark makes it easier to obtain commercial loans due to the possibility of issuing bonds on the basis of a large pool of commercial loans, especially benefiting small and midsized corporations.

The *first* requirement is that the bank is authorised by the FSA to establish a refinancing register. Authorisation requires that the bank's organisation and resources are adequate to fulfil the task of keeping and maintaining a refinancing register.[137] Authorised banks can be found in the public register held by the FSA. The SPV must also appoint an independent supervisor, who must register with the FSA. The independent supervisor is to supervise every refinancing transaction.[138]

The *second* requirement is that the bank registers the assets sold to the SPV on each transaction. The register must clearly and fully identify the registered assets, including security ranking, identification of the SPV, entry date of the asset and, if possible, the expected exit date of the asset.[139] The refinancing register can only include loans and lease agreements relating to commercial activities and securities, derivatives etc. connected to such loans.[140]

The *third* requirement is that the bank does not control the SPV, i.e. the bank or any other group corporation do not control more than 20 pct. of the voting rights in the SPV, the bank or any other group corporation cannot replace the majority of the members of the top management in the SPV and no members of the management of the SPV are also part of the management in the bank or any other group corporation.[141]

The *fourth* requirement is that the SPV must issue bonds of a denomination of at least EUR 100,000.[142] The idea behind this requirement is to only make corporate bonds attractive for investors who understand the complexity and risk involved.

If the above-mentioned requirements are fulfilled a bank can use the securitization model as implemented in the Danish legislation as of January 1, 2014. The assets are considered to be transferred

[137] See Sec. 152 I, Para. 2
[138] See Sec. 152 r and 152 s.
[139] See Sec. 152 j, Para. 2
[140] See Sec. 152 p.
[141] See Sec. 152 k, Para. 2.
[142] See Sec. 152 k, Para. 5.

to the SPV from the moment the assets are registered in the refinancing register and with effect from that date in regard to creditors of the bank etc. However, the assets must be clearly identified in the register – otherwise the assets are not considered to be sold.[143] The bank is still responsible for administration of the assets in relation to the debtor (payments and offsetting)[144] and tax authorities.[145]

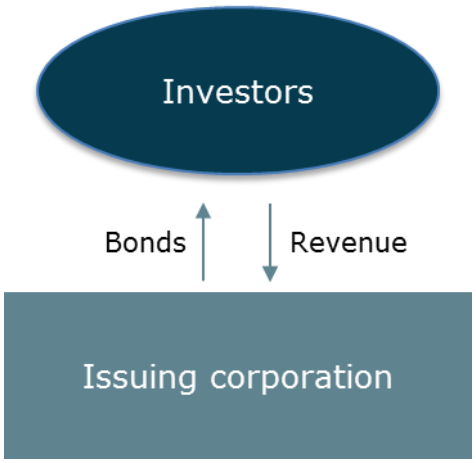
The bank is also responsible for the part of the prospectus and other material from the SPV related to assets in the refinancing register.[146] Furthermore the bank is obliged to disclose information in relation to the asset in the refinancing register to the SPV, if the issued bonds are traded on a regulated market and the information is of significant value, and can do so without consent from the debtor.[147]

4. Tax Consequences

A corporate bond is for tax purposes considered debt for the issuing corporation and a claim for the investor. However, the process of issuing the bonds ranges from a "simple" direct issue of corporate bonds to securitization with a trustee to represent the investor. The tax consequences are analysed in the following sections.

4.1 Direct Issuing of Corporate Bonds

In a direct issuing of corporate bonds the corporation in need of external capital directly issues the bonds to the investors and in return receives revenue from the investors. This can be illustrated as follows:



The tax consequences for a Danish issuing corporation are the revenue received and repaid, as well as interest paid and capital gains/losses on the corporate bonds. The revenue received is tax exempt and

[143] See Sec. 152 n, Para. 7.
[144] Offsetting can be waived by agreement.
[145] See Sec. 152 n, Para. 4-6.
[146] See Sec. 152 l.
[147] See Sec. 152 m.

the repayment of the revenue is not deductible. Interests paid on the corporate bonds are deductible, unless the corporation is affected by the interest limitation rules in Denmark.[148] Further capital losses on the bond are deductible, but can be denied according to the interest limitation rules in Denmark.[149] Should the issuing corporation obtain a capital gain on the bonds, such a gain is taxed in Denmark. However, a capital gain is tax exempt if the investor and the issuing corporation are group companies or the gain arises as part of a debt relief.[150] Capital gains and losses on the bonds are taxed/deducted when realised. The corporation can elect to use the *mark to market* principle on listed bonds and bonds issued in a currency other than Danish kroner.[151] Lastly, is should be noted that expenses *directly* associated with the issuing of the bonds can indirectly be deducted by adding these costs when determining a gain or loss. However, this does not include cost related to the overall structuring, assessments of the market, due diligence, etc.[152]

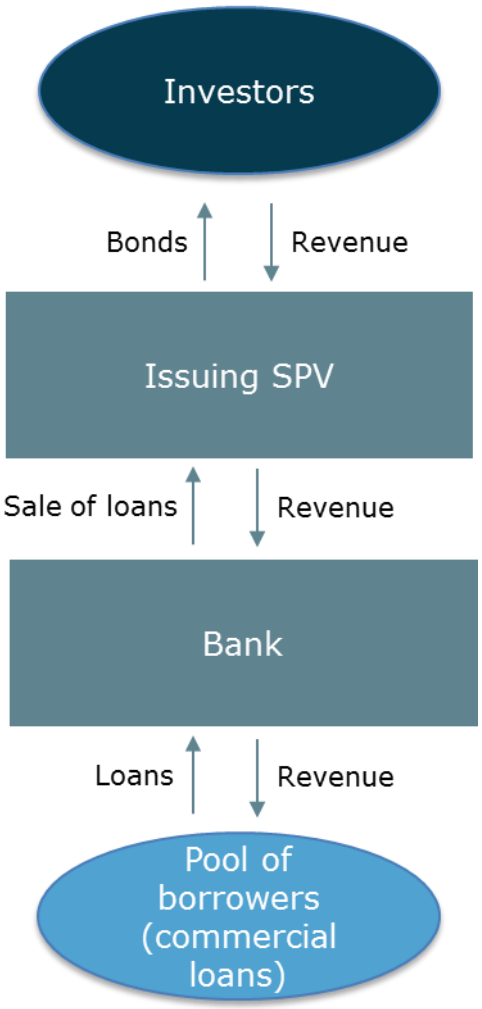
The tax consequences for the investor are more complex. The following table sums up the tax consequences in Denmark for investors:

	Status	**Interests**	**Capital gains**	**Capital losses**
Individual	Resident	Taxable	Taxable if trading professionally or net gains exceed 2,000 DKK	Deductible unless claim against a controlled corporation
	Non-resident	Tax exempt	Tax exempt	Not deductible
Corporation	Resident	Taxable	Taxable	Deductible unless claim toward group corporation
	Non-resident	Tax exempt Specific exemptions do apply to group companies	Tax exempt Specific exemptions do apply to group companies	Not deductible

[148] Cf. Sec. 6 of the State Tax Act and Sec. 6 of the Claim and Debt Tax Act. For an overview of the Danish interest limitation rules; see *Tell*: Nordic Tax Journal, 2013, p. 271.
[149] Cf. Sec. 6 of the State Tax Act and Sec. 6 of the Claim and Debt Tax Act. For an overview of the Danish interest limitation rules; see *Tell*: Nordic Tax Journal, 2013, p. 271.
[150] Cf. Sec. 6, 8 and 24 of the Claim and Debt Tax Act.
[151] Cf. Sec. 25 of the Claim and Debt Tax Act.
[152] Cf. the Danish Supreme Court in SKM2014.87.HR.

4.2 Securitization

The adoption of a register based securitization model in Denmark in January 1, 2014 enabled banks to sell commercial loans to a SPV etc., which can then issue corporate bonds secured in the pool of commercial loans, as described in section 3.2.2. Securitization involves at least three steps: (1) issuing of commercial loans from a bank, (2) sale of the commercial loans, and (3) the issuing of corporate bonds. This can be illustrated as follows:



First, the commercial loans involve an individual or corporation as the borrower (debtor) and a Danish bank as the lender (creditor). The tax consequences for the borrower depend on whether the borrower is an individual or a corporation.

An individual can deduct interest, while capital losses on the debt are only deductible if the loan is issued in a currency other than Danish kroner.[153] A capital gain on the debt is, as a main rule, tax exempt, but

[153] Cf. Sec. 6 of the State Tax Act and Sec. 20 and 23 of the Claim and Debt Tax Act.

exceptions do apply.[154] A corporation can deduct both interest and capital losses as a main rule.[155] A capital gain on the debt is taxed, unless the investor and the issuing corporation are group companies or the capital gain arises as part of a debt relief.[156]

The bank as the lender will be taxed on the received interest and capital gains on the claim. A capital loss is deductible, unless the borrower is a group corporation or a tax treaty precludes taxation of interests/gains.[157]

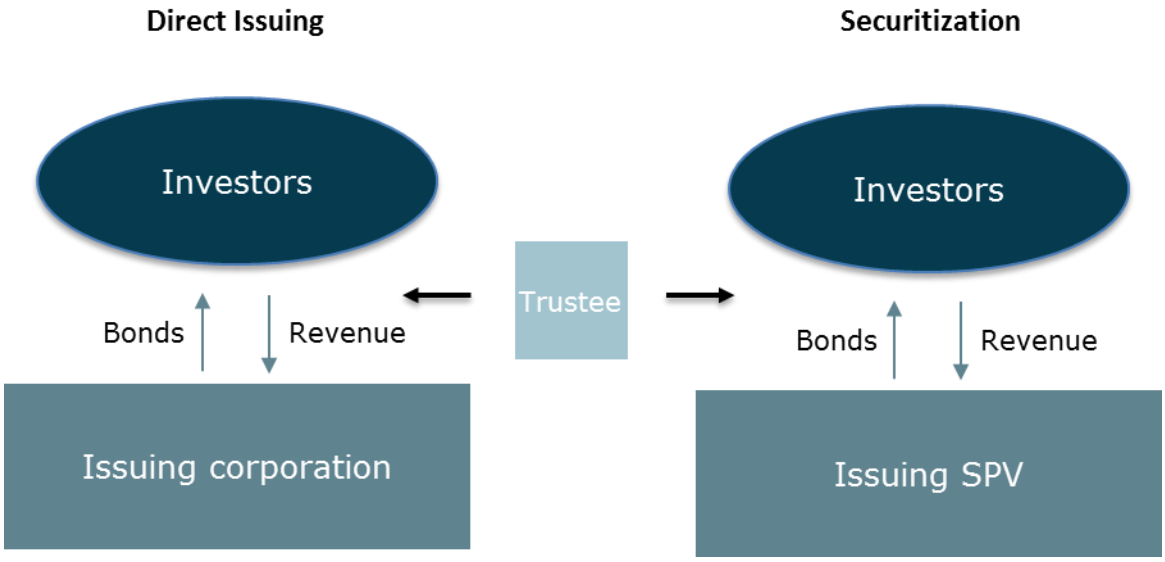
Second, the sale of the commercial loans involves a bank as the seller and a SPV as the buyer. The sale of the loans may cause a capital gain or loss on the loans for the bank. As mentioned above a capital gain is taxable while a capital loss is deductible, unless there is a claim toward a group corporation or a tax treaty precludes taxation of interests/gains.[158] The SPV as the buyer of the loans would obtain a new purchase price including expenses *directly* associated with purchase of the loans if the SPV is residing in Denmark. If the SPV is resident outside of Denmark, e.g. a limited liability corporation, a collective investment scheme for professional investors, a SIKAV or securities fund, the tax consequences would need to be analysed in terms of the specific situation of the SPV in that country.

Third, the issuing of bonds involves a SPV as the issuing corporation and investors, such as individuals or corporations. The specific organisation of the SPV will determine the subsequent tax consequences. If the SPV is a resident in Denmark the tax consequences are closely analysed in section 3.3.1. In summary, a Danish SPV is tax exempt in relation to the revenue received from the issuing of the bonds, while interests paid on the corporate bonds, as well as capital losses on the bond, are deductible.[159] If the SPV obtains a capital gain on the bonds such a gain is taxable, unless the investor and the SPV are group companies or the capital gain arises as part of a debt relief.[160] The tax consequences in Denmark for the investors are also analysed in section 3.3.1.

4.3 The Use of a Trustee

The trustee model enables the use of a trustee in Denmark to represent the investors in relation to the issued bonds, both in a direct issuing and in securitizations. This can be illustrated as follows:

[154] Cf. Sec. 20-24 of the Claim and Debt Tax Act.
[155] Cf. Sec. 6 of the State Tax Act and Sec. 6 of the Claim and Debt Tax Act.
[156] Cf. Sec. 6, 8 and 24 of the Claim and Debt Tax Act.
[157] Cf. Sec. 6 of the State Tax Act and Sec. 3-5 of the Claim and Debt Tax Act.
[158] Cf. Sec. 6 of the State Tax Act and Sec. 3-5 of the Claim and Debt Tax Act.
[159] Cf. Sec. 6 of the State Tax Act and Sec. 6 of the Claim and Debt Tax Act.
[160] Cf. Sec. 6, 8 and 24 of the Claim and Debt Tax Act.



The trustee must be a limited liability corporation and act as a representative for the investors[161] to the mutual benefit of both the investors and the issuing corporation/SPV. The trustee is to act in accordance with the terms agreed upon, which usually would include the trustee to be a single point of contact for both the investors and the issuer, monitor the loan, hold security on behalf of the investors, coordinate meetings, represent the investor in default situations, etc. The trustee is usually paid an annual fee from the issuer (issuing corporation/SPV) and not by the investors. The use of a trustee therefore raises a least two issues: (i) the tax treatment of the fee and (ii) whether the trustee constitutes a permanent establishment for the investors.

4.3.1 Tax treatment of the fee

If the trustee is residing in Denmark the fee is taxed in Denmark.[162] A fee to a non-resident trustee is only taxed in Denmark if the trustee has a permanent establishment in Denmark to which the fee is allocated. The deductibility of the fee is less obvious and several considerations should be made.

First, the fee may be considered a deductible operating expense. However, this requires that the fee paid to the trustee is related to acquiring, ensuring and maintaining taxable income.[163] In other words, the fee must be closely related to the business of the issuing corporation. Case law on financing costs as a deductible operating expense has traditionally been very strict, since borrowing is typically considered an establishment costs.[164] Only if it can be directly and unambiguously identified, that the borrowed money is used in the core business, has a corporation been granted the right to deduct such cost as an operating expense. In TfS 1987.198 LSR the National Tax Tribunal stated that only finance corporations

[161] Cf. Sec. 4 b and 4 d of the Danish Securities Act.
[162] Cf. Sec. 4 of the State Tax Act.
[163] Cf. Sec. 6 a and SKM2012.13HR.
[164] See *Bolander* in SR.2010.166 .

and similar corporations can claim a deduction as an operating expense – the case related to a 1,5% credit commission. On the basis hereof an issuing corporation in a direct issuing, as described in section 3.3.1, cannot deduct a fee paid to a trustee, since the issuing of bonds is not the core business of the corporation. On the other hand, when using a SPV as described in section 3.3.2, the SPV's main purpose is to issue securities and it could therefore be argued that the fee paid to the trustee can constitute a deductible operating expense.

Second, the fee may be considered a deductible interest payment.[165] Interest is defined as a periodic payment to the lender for providing capital, which is calculated as a percentage of the remaining outstanding debt.[166] However, even if the fee is calculated as a percentage of the remaining outstanding debt, the payment is to the trustee and not the lender and the payment is made for the monitoring of the bonds and representation of the investors and not for providing capital, thereby disqualifying the fee as a deductible interest payment.

Thirdly, the fee may be considered an ongoing interest-like payment, which can be deducted according to Sec. 8, Para. 3, point a or b of the Tax Assessment Act. The idea behind the rule is that these ongoing interest-like payments, such as ongoing premiums for loans or securities related to debt, are so similar to interests that they are also deductible.[167] In SKM2007.47SR the National Tax Board confirmed that a borrowers ongoing payment to the lender (premium for mortgage security equal to the payment made by the lender to an insurance corporation), which is calculated on the basis of the outstanding debt, maturity and mortgage ratio, constituted a deductible interest-like payment. However, unlike a trustee fee, it was a payment between the lender and the borrower and further the security was related to the debt. A trustee fee is therefore most likely not deductible according to Sec. 8, Para. 3, point a or b of the Tax Assessment Act.

Lastly, the fee may be considered a transaction expense (cost of borrowing), which can be added when determining a capital gain/loss. Such costs include costs associated with acquiring of claims and incurring of debt, for example charges, brokerage fees, upfront fees and stamp duties and similarly costs incurred when selling the claim or repaying the debt.[168] From the examples given it is not possible to make any accurate determination of the relevant borrowing costs, however the examples are typical borrowing costs closely related to the borrowing. Given the nature of the examples of borrowing costs, that are mentioned the Supreme Court found in SKM2012.2H and SKM2014.87.HR, costs must be attributable to the debt creation or repayment. This has recently been confirmed by the High Court of

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165 Cf. Sec. 6 e.
166 See *Jeppesen* in SPO 2007.331.
167 Cf. Folketingstidende 1969-70, Appendix A, column 328 and *Bolander* in SR.2010.166.
168 Cf. Bill L 194 1996-97

Eastern Denmark in SKM2014.576.ØLR, which concerned fees to investment banks in connection with the issuing of corporate bonds. The High Court of Eastern Denmark found that that the fee to the investment bank without a doubt included services related directly to debt creation, but also services of a more general nature (structuring etc.). The High Court of Eastern Denmark then found that the corporation had not established what part of the costs that could be included, and the Court could therefore not determine or estimate the cost that could be included. In regard to the fee paid to a trustee these do not seem to be closely attributable to the debt creation, but instead the following and ongoing monitoring of the debt – not the debt creation - and hence cannot be added when determining a capital gain or loss.

In conclusion the fee paid to the trustee by the issuer only seems deductible if the issuing corporation is a financing corporation such as a SPV.

4.3.2 Permanent establishment

A permanent establishment is according to the general definition in Danish law a fixed place of business through which the business of an enterprise is wholly or partly carried on.[169] This definition contains three conditions; (i) the existence of "a place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment, (ii) the place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence and (iii) the carrying on of the business of the enterprise through the fixed place of business.[170]

The term permanent establishment has been addressed several times in relation to private equity structures, where a management corporation administrates the investor's investment, for example equity investment through partnerships. Lately in SKM2013.899.SR the National Tax Board found the investors to have a permanent establishment at the place of the management corporation, which contradicts former case law.[171] Controversially the National Tax Board found the offices of the management corporation to be at the disposal of the investors, due to the management of the partnership being identical to the management of the management corporation and that the yearly general meeting where held at the offices of the management corporation.

However, even if the decision of the National Tax Board is correct it does not seem to have any implications for the use of a trustee to represent the investors in relation to corporate bonds. The trustee

[169] For more on permanent establishments, see *Skaar*: Permanent Establishment – erosion of a tax treaty principle, Kluwer Law and Taxation Publishers 1991, *Cahiers de Droit Fiscal International:* Is there a permanent establishment, International Fiscal Association 2009, Vol. 94a., *Reimer, Urban and Schmid*: Permanent Establishments, Wolters Kluwer Law & Business 2011 and *Laursen*: Fast driftssted, Jurist- og Økonomforbundets forlag 2011.
[170] Cf. Sec. 2 of the Act on Taxation at the Source and the Corporation Tax Act.
[171] See *Wittendorff*: Fast driftssted for investorer i private equity funds - vidtrækkende praksisændring, SR Skat, 2014, SR 2014, 112.

model differs significantly from a private equity structure, since the private equity structure involves an assessment of whether or not the partnership constitutes a permanent establishment for the investors, while no such partnership is involved in the trustee model (a limited liability corporation). It is merely a passive investment involving independent representation. The use of the trustee model therefore does not cause a permanent establishment according to the general definition, since there is no fixed place of business at the disposal of the investors (bondholders).

Instead a trustee might constitute a permanent establishment due to the trustee being a person (agent) acting on behalf of an enterprise and who habitually exercises the authority to conclude contracts in the name of the enterprise.[172] Such a deemed permanent establishment, due to a so called dependent agent, might cause taxation in Denmark for non-resident investors. A dependent agent includes both individuals and corporations and the agent does not need to be a resident in Denmark or have a place of business in Denmark to constitute a permanent establishment for the investors. However, an enterprise is not deemed to have a permanent establishment merely because it carries out business through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. A person will therefore not constitute a permanent establishment if the person is independent of the enterprise both legally and economically and the person acts in the ordinary course of his business when acting on behalf of the enterprise.[173]

An independent agent is responsible to his principal for the result of his work, but not subject to significant control with respect to the manner in which that work is carried out. The fact that a principal is relying on special skill and knowledge of the agent is an indication of independence. Furthermore, in determining (in)dependent status it is relevant to analyse whether the agent represents one or numerous principals. In regard to whether or not the agent acts in the ordinary course of his business it must be examined which business activities are customarily carried out within the agent's trade as an independent agent.[174] A trustee would usually represent numerous principals (investors) and would not be subject to significant control with respect to the manner in which that work is carried out. Furthermore, the trustee is usually specialised in monitoring, coordinating and facilitating the bonds etc. in the ordinary course of business as an agent. In conclusion it is therefore very unlikely that a trustee constitutes a permanent establishment for the investors.

[172] Cf. Sec. 2 of the Act on Taxation at the Source and the Corporation Tax Act. See also *Laursen*: Fast driftssted, Jurist- og Økonomforbundets forlag 2011, chapter 4 and 5.
[173] See comments to the OECD MC 2014 art. 5 and *Reimer, Urban and Schmid*: Permanent Establishments, Wolters Kluwer Law & Business 2011, pp. 95-108.
[174] See comments to the OECD MC 2014 art. 5.

5. Conclusion

The report from November 2012 on *Corporate Bonds as a Source of Financing for Small and Midsized Corporations* has resulted in significant regulatory changes with the adoption of bill 46 2013-14. The goal is to create a proper sized bond market, which enables spread and liquidity in the market by introducing a trustee model to benefit small, midsized and larger corporations.

Furthermore, the introduction of a trustee and securitization through a registered model enables corporate bonds to be issued on the basis of a large pool of commercial loans, which can be resold to adjust to the tightened bank regulations. It is thereby easier for banks to issue commercial loans, which benefits both small and midsized corporations. Only the future will tell if the bond market in Denmark will be as successful as in other countries, such as Norway and Sweden.

The tax consequences of the issuing of corporate bonds depend on the specific situations of the participants in the transactions. This article has analysed the tax consequences from a general point of view in section 4.1 in relation to a direct issuing of corporate bonds, section 4.2 in relation to securitization and section 4.3 in relation to the use of a trustee.

Chapter 4 – Allowance for Corporate Equity – Overview of existing Equity and Dividend Deduction Regimes and the International Tax Law treatment hereof

Jakob Bundgaard[175]

1. Background

The debt equity conundrum has been approached by various means in different jurisdictions. The debt bias is a well-documented fact and a global trend in neutralizing the treatment of debt and equity is seen[176]. Relevant measures include means of reducing the appeal for debt financing by way of restricting interest deductibility or reclassifying debt into equity[177]. Another approach includes allowance for equity or dividend deductions. The latter approach stimulates equity investments rather than restricting debt financing. Economic theory advocates such an approach. An increase in the usage of equity- and dividend deduction regimes is seen in recent times where several countries have followed this approach. This tendency necessitates legal clarification of international tax issues raised by such regimes.

This presentation analyzes ACE-regimes and discusses the implications for international tax law of such approaches. This contribution does not address debt-equity hybrid instruments (in concreto debt-like equity), which are considered debt from the perspective of the issuer, and the yield as a consequence hereof is considered deductible interest.

2. Theoretical approaches favoring equity and dividend deductions – Allowance for Corporate Equity (ACE)

Economic theory has developed different solutions with the objective of neutralizing the tax treatment of debt and equity.

The solution proposed to obtain full neutrality is referred to as a Comprehensive Business Income Tax (CBIT), which denies deductibility by firms and treats debt as the current corporate income tax treatment of equity. There are however, no real-world examples of CBIT[178].

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[175] Managing director, PhD, CORIT Advisory LLP, Honorary professor, Aarhus University.

[176] See for a recent analysis e.g. *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011.

[177] See for an overview of possible policy responses *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011, p. 14 et seq. and *Blessing* in Bulletin 2012, p. 209 et seq.

[178] See *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011, p. 16 and See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.

A model offered to solve the problems is traditionally referred to as Allowance for the Cost of Equity (ACE) which has been on and off tax reformers' agendas since the 1980's[179]. Since then proponents have repeatedly argued in favor of such a tax. The ACE has a number of interesting properties[180]. The idea of an ACE is to address the difference in the treatment of debt and equity by allowing firms to deduct a notional interest rate on their equity as well. As a consequence the ACE reduces the debt financing bias and reduces the tax motivations for leverage and consequently reduces the need for specific anti avoidance and anti-arbitrage legislation. On the other hand ACE systems may also be seen as a mean to stimulate equity investment in the corporate sector of the country in question. In the present economic environment ACE may be seen as a means of increasing the attractiveness of a capital importing country.

In theory the Allowance for Corporate Capital (ACC) is even more neutral. Under the ACC-model, the interest deduction is abolished and replaced by a deduction for the notional risk-free return on all capital, irrespective of whether it is financed by debt or equity[181]. In the United States, such a system has been proposed several times over the years. The model presently most popular is the "COCA" or "cost of capital allowance" system. This model has been advocated primarily by *Kleinbard*[182].

One of the most recent proposals is seen in Sweden where the topic has been extensively analyzed[183]. On 12 June 2014, the Swedish Committee on Corporate Taxation published a proposal to reform the corporate income tax regime. The most important details of the proposal, which should apply from 1 January 2016, are summarized below. The Committee has not found any grounds that motivate a difference in the tax treatment of equity and debt. Moreover, it was found that the previous academic debate regarding the abolishment of the difference in the tax treatment of equity and debt and the distortions caused hereby were not perceived sufficiently serious to lead decision makers to consider there was any call for reform. This has changed due to large scale conversions of equity into debt and the moving of capital into low tax jurisdictions.

The main proposal includes a restriction of interest deduction and other financial costs, where such costs should be restricted to those costs for which there is a corresponding financial income. This means that the net financial costs would no longer be deductible. In this context, the Committee also concluded that the definition of financial costs should be expanded and, inter alia, include the following items:

179 *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 3. A more firm reform proposal was presented by Institute for Fiscal Studies in 1991: A General Neutral Profits Tax, Fiscal Studies Vol. 12, pp- 1-15 (IFS, 1991, *Deveraux & Freeman*) and *Gammie* in ET 1992, p. 238 et seq.: Corporate Tax harmonization: An Ace Proposal. See also Institute for Fiscal Studies, Miirlees Review, Reforming the tax system for the 21st century, Tax by Design, pp. 421-425 and *Blessing* in Bulletin 2012, p. 212. See also See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.

180 *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 4 et seq.

181 See *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 17 and Blessing in Bulletin 2012, p. 211.

182 See Tax Notes, 3 January 2005, at 101; and *Taxes* 1989, at 943.

183 See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.

interest, exchange rates differences, losses on financial instruments; and the interest component on rental payments. In addition, the Committee suggested abolishing the current interest deduction restrictions concerning intra-group debts. Furthermore, group companies should be allowed to offset their financial income against financial costs of other group companies. As compensation for the abolition of the deduction for net financial costs, it is proposed to introduce a standard deduction for all financial costs ("a financing allowance")(including the cost of equity) at a rate of 25% of the taxable profit. As a result, the standard corporate income tax (CIT) rate of 22% would be reduced to 16.5%.

3. Overview of Country Practices: domestic equity- and dividends deduction regimes

As mentioned an increased use of equity- and dividend deduction regimes is seen. ACE-deductions have not only been a theoretical exercise. Accordingly, a number of states have enacted such measures with certain variations.

French companies established prior to 1988 have had the opportunity to deduct from their taxable income 100% of distributed dividends provided the contributions were made in cash. The system was introduced to encourage shareholder equity financing but was limited to a ten year period[184]. The system was amended (reducing the rate of deductibility from 100 to 53,4) in order to correct the imbalance between the actual corporate taxes paid and the total tax benefit including shareholder imputation credit (avoir fiscal).

An ACE system was introduced in Croatia in 1994, followed by Italy in 1997 and Austria in 2000. All these countries have later abolished their ACE-system[185]. Presently variations of ACE systems exist in Belgium, Latvia, Brazil and Italy. Recently, an ACE has been advocated by the Mirrlees Review for the U.K. (Mirrlees and others, 2011). That report emphasizes that a British ACE could bring important economic benefits. A recent tax committee of the Dutch government has also proposed an ACE-regime[186].

Greenland

Greenland allows deduction for all payments. Thus, subject to certain conditions, distributed dividend is deductible for a Greenlandic distributing company.

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[184] See the former art. 214 A C.G.I. commented by *Lazarski* in ET 1988, at p. 264 et seq. and *Jacobs* in Intertax 1989, p. 466.
[185] The global practice of ACE systems has been analyzed by *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006. *De Mooij* considers ACE a promising tax policy option in Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, May 3, 2011, SDN/11/11.
[186] Ministry of Finance of the Netherlands, 2010, Continuity and Renewal, report of the Studygroup on tax Reform.

Brazil - 1996

Since 1996 Brazilian law has contained a favorable regime allowing deductions on equity[187]. Such payments are referred to as ”Juros sobre o Capital Próprio” (JCP). Typical English translations of JCP are ”Interest on equity capital (IOE), ”Interest on Net Equity (INE)” or ”Interest over Capital (IOC)”. The abbreviation JCP is used in the following.

JCP is considered an alternative to ordinary dividend distributions. As such the JCP system is not an ACE system and the JCP deduction only applies to actual payments. According to domestic Brazilian law JCP is treated as a special type of interest and is treated as interest.

The JCP mechanism allows for a legal entity to opt to pay interest in its own capital calculated by the application of a long term interest rate set by the government (“Taxa de Juros de Longo Prazo”) over the entity’s equity. JCP paymentscan only be paid up to half of the amount of (whichever is higher): (i) the entity’s profits of the current year, before the JCP’s deduction; or (ii) the entity’s accumulated profits[188]. The JCP deduction requires a formal decision in the paying company. Moreover, the JCP requires a corresponding taxation at the level of the recipient, being a resident or a foreign tax payer (the shareholder). The tax value of the deduction is 34%, however corresponded by a 15% withholding tax.

According to Brazilian law there is no money flow requirement[189]. The payor is allowed to register the JCP payment as a liability or, by shareholders’ decision, the declared JCPs can be recapitalized by way of capital increase of the payor company. In either case, the payor can deduct the JCPs, even though no actual payment has been made to the payee, and the payee will be taxed at the same moment the deduction is taken. Thus, regardless of the money flow, the payor’s deduction is fully linked to the payee’s taxation[190].

There has been lenghty discussions before the Superior Court of Justice as to the charging of certain contributions on JCP and according to the final ruling it should be treated the same way as interest is and not as dividends.

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[187] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared in European Tax Studies, 1/2010 and *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 10 et seq.
[188] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 4.
[189] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 6.
[190] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 6.

Belgium – 2005

With effect from tax years since 2007 Belgium introduced Notional Interest Deduction rules (NID)[191]. In essence the rules neutralize the treatment of debt and equity. In terms of foreign investments it seems that the introduction of the NID system put Belgium back on the tax map as a replacement of the Belgian coordination center[192].

The measure permits Belgian tax-resident companies and Belgian branches of non-resident companies to claim a tax deduction for their cost of capital by allowing them to deduct a notional interest at a rate calculated on the aggregate amount of their equity including retained earnings.

The NID is based on the company's share capital plus its retained earnings, as determined for Belgian generally accepted accounting principles purposes and as of the last year-end date.

The NID rate is based on the prior year's average of the monthly published interest rates, which is paid on 10-year Belgian government bonds. The rate is adjusted annually up or down by a maximum of 1 percentage point, and the maximum rate is currently capped at 6.5%. The annual rate is 3% for 2013 and 3.5% for SMEs. The part of the NID deduction that cannot be set off against the profits of the current year can be carried forward for seven years.

No actual cash flow is required under the Belgian NID regime. The NID is a fictitious interest cost on the adjusted equity capital. This can be put as follows: NID = Notional Interest x adjusted equity.

For obvious reasons the Belgian NID regime contains anti-abuse provisions with the objective to ensure that the same equity is not included in the deductible equity of more than one taxpayer.

Latvia - 2009

With effect from 1 January 2009 Latvia introduced a Notional Interest Deduction Regime. According to this regime a "notional interest" is deductible from the taxable income[193]. The calculation is based on the retained earnings from tax periods starting after 31 December 2008 and the annual average weighted interest rate on loans in lats to domestic non-financial companies.

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[191] See *Gerard* in ET 2006, p. 156 et seq., *Springael* in DFI 2006, p. 47 et seq., *Bombeke & von Frenckell* in DFI 2006, p. 167 et seq., *Quaghebeur* in Tax Notes Int'l June 20 2005, p. 1035 et seq., *Quaghebeur* in Tax Notes Int'l November 12, 2007, p. 627 et seq., *Haelterman & Verstraete* in Bulletin 2008, p. 362 et seq., *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010 and Notional Interest Deduction: an innovative Belgian tax incentive- Tax year 2013 – Income 2012, Federal Public Service.

[192] Certain aspects of the Belgian NID regime have been brought before the ECJ in Case C-350/11 Argenta Spaarbank. The ECJ found that the rules were contrary to EU law. See *de Broe* in ECJ developments, 2011, p. 16 et seq.

[193] See *Lasmane & Rumba* in World Tax Advisor 2008, 5 December.

Italy – 2011

Italy also (re-)introduced a Notional Interest Deduction regime on 22 December 2011[194]. The deduction aims to encourage self-financing and alleviate the tax imbalance between Italian companies funded with equity and those funded with debt. The Italian version of the ACE regime stands for "Aiuto alla Crescita Economica". Italy's Minister of Finance issued a decree on 14 March 2012 containing implementation rules and clarifications with regard to the notional interest deduction introduced at the end of 2011.

Starting with the fiscal year 2011, the ACE rules entitle Italian entities (i.e. companies, individual firms and partnerships, as well as branches of nonresident companies) to a tax deduction computed by applying a notional yield to the increase in their net equity (the "ACE base"). For the first year of application (i.e. 2011), the ACE base is the amount of equity existing at the end of that year less the amount of equity at 31 December 2010 (excluding profits earned in 2010).

In subsequent years, the ACE base is the base carried forward from the previous year: (1) increased by cash contributions and apportionments of profits to capital reserves (exceptions for apportionments to specific reserves that are not available for distribution, increasing capital or covering losses); and (2) reduced by distributions of equity to shareholders, acquisitions of new interests in participated companies and acquisition of going concerns (the March decree provides for additional reductions under specific anti-abuse rules, if applicable). Should the amount of the notional yield (i.e. the ACE deduction) for a year exceed the total net income declared, the excess may be carried forward and increase the amount deductiblefrom income for subsequent tax periods.

The notional yield is fixed at 3% for the fiscal years 2011, 2012 and 2013. After 2013, the notional yield will be determined annually by a Ministerial decree based on the yields on Italian treasury bonds and can be increased by an additional 3% to compensate for higher business risk.

The decree provides specific anti-avoidance rules that place limitations on the ACE base and, consequently, the amount of the ACE deduction. These rules primarily target transactions that lead to a duplication of the tax deduction in the context of corporate groups (more precisely, in transactions involving entities linked by a control relationship). In particular, the following transactions will reduce the ACE base:

- Cash contributions made after the end of the tax year including 31 December 2010 to controlled entities or entities under common control (even if the control relationship is a consequence of the contribution concerned);

[194] See *Leone & Zanotti* in ET 2012/8 and World Tax Advisor 18 May 2012. Italy also introduced an ACE system in 1997 under the calling name: Dual Income Tax System. See *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 7 et seq. for an overview of the historical ACE system in Italy.

- Acquisitions of businesses and/or participations previously owned by controlled entities or entities under common control;
- Increases in relation to the amount shown in the financial statement as of 31 December 2010, in amounts receivable from loans provided to controlled entities or entities under common control;
- Cash contributions received from nonresidents controlled by residents; and
- Cash contributions received from an entity or individual domiciled in a black-list jurisdiction (even if no control relationship exists between the nonresident and the recipient of the cash contribution).

4. International tax issues raised by domestic equity deduction regimes

No international consensus exists regarding the tax treatment of ACE regimes. Traditional ACE regimes, however, should not likely trigger any tax consequences in the state of residence of the investor. One concern if whether dividends payments paid by companies resident in countries allowing ACE deductions would then continue to be creditable against foreign corporate income taxes, in countries that use the credit system. One source reports that experience with the operation of ACE-style relief in Belgium and Croatia, does not suggest that this is a problem[195].

In the specific case of Brazilian JCP payments and similar dividend deduction regimes there is an actual cash flow in the form of dividends payments.

A specific anti-arbitrage regime exists in certain countries including Germany and Denmark with the objective to deny participation exemption regarding such deductible inbound dividend payments[196].

The specific application of this provision with respect to JCP has not been analyzed in Danish law. Consequently, the tax treatment of JCP in Danish law is based on a classification of the payments according to generally applicable tax principles. The uncertainty is obvious since JCP shows traits of dividends and interest. Domestic uncertainty on the classification within Brazil adds to this uncertainty. According to Danish law it seems most correct to classify JCP payments as dividends for domestic tax purposes. This conclusion is based on the very broad notion of dividends in Danish law as any payment from a company to its shareholders which is also broadly interpreted in case law. This classification applies irrespective of any diverging classification according to the law of the source state since it is a generally acknowledged principle that any foreign transaction for Danish tax purposes must be classified on the basis of Danish tax law principles. The currently applicable notion of interest payments

[195] See Institute for Fiscal Studies, Miirlees Review, Reforming the tax system for the 21st century, Tax by Design, p. 446.
[196] See § 20 Abs. 1, EStG for German tax law and SEL § 13(2) for Danish tax law.

moreover requires the existence of a debt obligation in order to qualify as an interest payment. This specific circumstance disqualifies JCP payments as interest payments.

Once JCP payments are classified as dividends the next question is to assess whether the anti-arbitrage provision in SEL § 13, par. 1(2) applies. This provision denies participation exemption when dividends are deductible for the paying company.

Since the enactment of act no. 98 of 10 February 2009 with effect from distributions made on 8- October 2008 or later the Danish participation exemption regime has contained explicit wording on deductible dividends. According to this, the participation exemption does not include dividends, where the dividend paying company can deduct the dividend payment, unless the taxation in other countries is reduced or eliminated according to the parent-/subsidiary directive.

In our opinion JCP payments should be considered deductible dividend payments in this specific context regarding the application of the Danish anti-arbitrage provision in SEL § 13, par 1(2). As a consequence JCP payments from a Brazilian subsidiary to a Danish parent company should be considered taxable dividends according to domestic law. However, as a general principle in international tax law such a result should be in accordance with the existing double tax treaties.

With respect to double tax treaties an international consensus on the classification of JCP-payments for treaty purposes seems to be absent. The relevant provisions in most double tax treaties based on the OECD model treaty would be Article 10 on dividends and Article 11 on interest payments.

I generally favor a tax treaty classification of JCP-payments as dividends. However, in a number of Brazilian tax treaties the definition of interest in article 11(4) deviates from the present OECD model in defining interest as.

> *"The terms "interest" as used in this Article means income form Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt claims of every kind as well as other income assimilated to income from money lent by the taxation law of the Contracting State in which the income arises.".*

It may be argued that this definition includes JCP-payments. Moreover, in a number of cases the Brazilian tax authorities have taken the position that JCP-payments should be classified as interest payments. Thus, JCP-payments are seemingly classified as interest payments for Brazilian tax purposes despite

debate on the topic. The view regarding the characterization under tax treaties has not been definitively reviewed by Brazilian courts[197].

In Brazilian commentary it has been submitted that JCP is covered by Article 10 as income derived from shares and, as such and, as such, should generate no doubt as to being included in the conventional concept of `dividends´ (and therefore subject to article 10 of the treaties). The Brazilian tax authorities, however, have been taking the position of considering JCP as being subject to Article 11 of tax treaties. In the case of more recent treaties with South Africa, Belgium, Chile, Israel, Mexico, Peru and Ukrania the Ordinances that regulate the application of treaty rules state clearly that "*in the case of interests, including JCP, subject to Section 11 of the Convention, the withholding tax shall not exceed ...*" Prior to those statements there is no referrence to JCP in the Brazilian tax treaties. In general there has been lenghty discussions before the Superior Court of Justice as to the charging of certain contributions on JCP and the final ruling has been that it should be treated the same way as interest and not as dividends, which suggests that the Brazilian courts would endorse the tax authorities understanding on this matter.

One question is whether JCP deductions can be said to neutralize a potential Brazilian withholding tax with the effect that there is no withholding tax actually paid. Such reasoning must be rejected since there is nothing different in the JCP deduction from a traditional interest payment, where a withholding does not cease to exist simply because the paying company has been allowed a deduction for the interest payment.

Although Brazilian tax law (and more recently, Brazilian tax treaties, with Mexico, South Africa and Israel) draw a distinction between JCP and dividends, several jurisdictions consider that JCP-payments is akin to income deriving from equity and thus can rely on the associated rules, which might be participation exemption[198].

It has been reported that JCP-payments have been classified as dividend payments for Spanish and German tax purposes, whereby the domestic participation regime has been found applicable. In Germany the Tax Court of Nürnberg analyzed the instrument in its decision of December 14, 2010 and concluded that the JCP-payments for German tax purposes would qualify as dividends, since at the end of the day they derive from the investment by the shareholder in the equity of the Brazilian company. The Spanish discussion has been concerned with the question of how the interaction should be between tax treaties and domestic law. In a Spanish case from 2014 the question was analyzed on the basis, that the Spanish tax authorities since 2011 challenged the applicability of the domestic participation regime

[197] See *Garrigues*: Brazilian interest payments on net equity (Juros sobre o capital próprio): An international perspective, p. 4.
[198] See *Garrigues*: Brazilian interest payments on net equity (Juros sobre o capital próprio): An international perspective, p. 5.

to JCP-payments. The Spanish High Court "Audencia Nacional" decided on 27 February 2014 that a Spanish parent company will be able to benefit from the Spanish participation regime since the "subject to tax" test would be met and since the JCPs according to the court fit better into Article 10 rather than into Article 11 of the tax treaties. One Spanish commentator has stated that the decision can still be reversed by the Spanish Supreme Court[199]. Despite the current BEPS debate, it is argued that JCP and other similar mechanisms contribute to healthier companies, as they provide for some relief in favor of equity financing. Moreover, it is mentioned that, in this case, there is no abuse or mismatches, but simply the use of a mechanism and enjoyment of intended effects provided for by tax legislation.

[199] See *Vallada* at http://taxcave.blogspot.dk/2014/03/spanish-decision-on-brazilian-interest.html, dated 25 March 2014.

Part II

Chapter 5 – Tax Treaty Treatment of Dividend Related Payments under Share Loan Agreements[200]

Katja Dyppel Weber[201]

Abstract

The article analyses some of the qualification and allocation challenges that dividend related payments under share loan agreements give rise to for tax treaty purposes. The analysis is based on constructed scenarios illustrating how inconsistent domestic allocation of the dividend related payments give rise to qualification and allocation conflicts for tax treaty purposes in cross-border situations. The main challenges concern to what extent dividend related payments may be covered by the term "dividends" in article 10 of the OECD double tax convention and to what extent the lender in a share loan agreement fulfils the beneficial ownership requirement.

1. Introduction

A share loan is generally characterized as a loan of listed shares, according to which one party lends its shares to another party for a specified period. During this period the borrower has disposal over the shares. There are various reasons why one would enter into share loan agreements, such as to hinder disturbance situations in stock trading, to bring additional return to the lender's share investment, for the borrower to benefit from changes in market value or to grant additional voting rights to the borrower during the loan period.[202]

A share loan agreement is an agreement of lent (restricted) ownership rights, which can entail that the right to sell the shares and the right to receive distributed dividends on the lent shares might not belong to the same party. Consequently, the design of share loan agreements may give rise to several challenges for tax law purposes.

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[201] PhD, Assistant Professor, Copenhagen Business School and Senior Associate CORIT Advisory P/S. The author can be contacted at: kdw.jur@cbs.dk.

[202] For these and other non-tax reasons for the use of share loan agreements; *see* P.H. Blessing, *Domestic and Treaty Anti-Abuse Rules as Applied to Dividends* in *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.), IBFD 2012), EC and International Tax Law Series, Vol. 8, p. 100, Online Books IBFD; R. Cordner, *Growth of Securities Lending Depends on Regulations, Securities Lending, the Taxation of International Stock Lending*, International Tax Review Supplement, 1992, pp. 2-4; M.C. Faulkner in F.J. Fabozzi & S.V. Mann (eds.), *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Inc., 2005, p. 21 et seq.; M. Gaffney, *Cross-Border Securities Lending and Qualified Securities Lending Regime*, Tax Notes International, 2011, p. 975 et seq.; M. Helminen, *The International Tax Law Concept of Dividend*, Wolters Kluwer, 2010, p. 108; and O.S. Penn, *Withholding Tax Issues in Cross-Border Equity Swaps: The Dividend Problem*, Tax Notes International, 1993, p. 927.

The domestic tax treatment of the payments under share loan agreements varies between jurisdiction. In cross-border situations, these inconsistent domestic tax treatments may give rise to qualification and allocation conflicts for tax treaty purposes, which may impose a risk of double taxation and consequently double non-taxation.

The purpose of this article is to identify and analyse some of the qualification and allocation challenges that the dividend related payments under share loan agreements give rise to for tax treaty purposes.[203] First, the general content of share loan agreements is introduced. This is followed by a brief overview of the relevant considerations for domestic tax purposes. Thirdly, the qualification of the dividend related payments for treaty purposes is analysed. For the purpose of simplification; this analysis is made under the assumption that the involved states apply the same allocation principles. Finally, on the basis of the qualification of the dividend related payments the allocation challenges, that may occur, are identified and analysed. These potential allocation conflicts are identified on the basis of three constructed scenarios.

2. The Content of Share Loan Agreements

According to a share loan agreement one party (the borrower) borrows (listed) shares from another party (the lender) often against the transfer of collateral.[204] Share loan agreements are often based on master agreements such as the Global Master Securities Lending Agreement produced by the International Securities Lending Association (ISLA). Two intermediaries, one on each of the parties' behalf may undertake the share loan agreements. These intermediaries arrange, manage and report on the lending activity and are often custodians, investment managers, third-party agents, brokers, investment banks, etc.[205]

Generally, share loan agreements stipulate that the borrower is entitled to obtain ownership rights of the shares and by termination of the agreement, the borrower is obliged to transfer the borrowed shares or shares of the same sort; quality as well as quantity to the lender. Under share loan agreements the borrower pays for the right to lend the shares. This remuneration for lending out shares may be a fixed amount or a variable amount such as a percentage of the market value of the lent shares over the duration of the agreement. Additionally, it may be agreed that the borrower obtains ownership rights of the shares, including voting rights on annual meetings and the right to sell the shares to a third party.[206]

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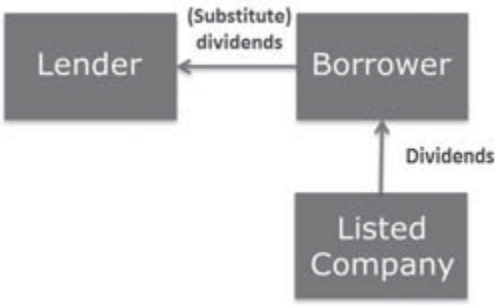
[203] Therefore, issues concerning relief of withholding taxes in practice, the proof of beneficial ownership, etc. are not dealt with in this article. However, these issues are of great importance in practice.
[204] *See*, for example, article 1.2 of the ISLA Global Master Securities Lending Agreement (2010).
[205] *See*, for example, Faulkner, *supra* n. 1, at p. 12 et seq.
[206] *See*, for example, Cordner, *supra* n. 1, at pp. 2-4; Faulkner, *supra* n. 1, at p. 4; E. Flink et al., *Securities Lending*, International Tax Review, 1994, pp. 51-54; Gaffney, *supra* n. 1, at p. 975 et seq.; M. Helminen, *supra* n. 1, at p. 170; and R. Avi-Yonah & L. Swartz, *US International Tax Treatment of Financial Derivatives*, Tax Notes International, 1997, pp. 787-800.

It is often agreed that the lender remains entitled to the dividends paid on the shares, either by a reimbursement of the gross dividends paid on the shares or an amount equal to the net dividends distributed during the term of the loan.[207] Based on the ISLA Global Master Securities Lending Agreement, the lender will usually expect to receive a substitute payment of the same amount as the dividend to which the lender would normally be entitled and thus, the borrower would therefore have to pay a substitute payment that exceeds the net dividend that it receives if withholding taxes are levied.[208] Accordingly, depending on the specific terms agreed, it might be argued that the payment constitutes a dividend in the hands of the lender, as the lender has maintained the ownership right to the distributed dividends and the borrower has merely passed on dividends. Figure 1 shows a simplified illustration of the cash flow stream of the dividend related payments.[209]

Figure 1: Dividend related payments under share loan agreements



3. Domestic Tax Considerations

The design of share loan agreements may give rise to several challenges for tax law purposes. In some countries, a share loan agreement is considered a sale of the lent shares for tax purposes, i.e. tax on realized gain/loss may be imposed. In other countries, a share loan agreement is classified as a loan in kind for tax purposes, i.e. the share loan agreement is not considered a sale as the lender is still recognized as the owner of the shares.

As an example, for US tax purposes, the income tax consequences of the share loan agreement itself were addressed in Rev. Rul. 57-451, according to which the loan of shares was not considered a sale. In 1978

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[207] This payment is generally referred to as a "substitute dividend" or as "in lieu of payments" or as "a manufactured dividend", *see,* for example, M. Gaffney, *supra* n. 1, at p. 977; Helminen, *supra* n. 1, at p. 170; and Penn, *supra* n. 1, at p. 927.

[208] It follows from article 6.21 of the ISLA Global Master Securities Lending Agreement (2010) that where income is paid in relation to any Loaned Securities:
Borrower shall, on the date of such Income is paid by the issuer … pay or deliver to Lender such sum of money ... equivalent to (and in the same currency as) the type and amount of such Income that would be received by Lender in respect of such Loaned Securities assuming such Securities were not loaned to Borrower and were retained by Lender in the Income Record Date.
See also, article 3(ii) of the ISLA Global Master Securities Lending Agreement, UK Tax Addendum according to which:
any Income comprising a payment, the amount (the "Manufactured Dividend") payable by Borrower shall be made without any deduction or withholding for or on account of any Tax, provided that Lender has supplied Appropriate Tax documentation.

[209] Figure 1 is based on the assumption that the borrower has not resold the borrowed shares.

the Congress enacted section 1058 of the Internal Revenue Code, which provides that when a taxpayer transfers securities pursuant to an agreement which meets specified requirements, no gain or loss shall be recognized on the exchange of such securities by the taxpayer for an obligation under such agreement, or on the exchange of rights under such agreement by that taxpayer for securities identical to the securities transferred by that taxpayer.[210]

The Canadian Income Tax Act has specific provisions dealing with share loan agreements. Provided that certain requirements are met; a transfer of securities under a share loan agreement is not deemed to be at disposition by the lender for Canadian income tax purposes.[211] Specific anti-avoidance rules may apply in order to deny this qualification.

In Denmark the tax treatment of share loan agreements are not governed by law but follows from administrative case law, as the question has not yet been dealt with by the courts. According to administrative case law, the lender of the shares is regarded as the owner of the shares if certain requirements are met.[212] Thus, also for Danish tax purposes; the loan of shares is generally not considered a sale.

For domestic tax law purposes, allocation of dividends typically follows from a general principle of attribution based on either legal or economic entitlement.[213] Therefore, the allocation of dividends does not necessarily follow the legal ownership of the shares but depends on the applicable principle of attribution.[214] In some jurisdictions such as Germany, Italy, New Zealand and Norway, it follows from general propositions that income (including dividend payments) cannot be alienated independently of its source, whereas the alienation of income generally is tax-effective in Argentina, Austria, Switzerland

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[210] For these rules *see,* for example, Avi-Yonah & Swartz, *supra* n. 5, at p. 790 et seq., W. Chip, *Are Repos Really Loans?*, Tax Notes International, Special Report, 2002, pp. 1057-1063; Flink et al., *supra* n. 5, at p. 52; Penn, *supra* n. 1, at p. 927 et seq.; and R.J. Shapiro in F.J. Fabozzi & S.V. Mann (eds.), *Securities Finance – Securities Lending and Repurchase Agreements*, John Wiley & Sons, Inc., 2005, p. 182 et seq. For case law, *see Calloway v. Commissioner* where the court found that the transaction was considered as a sale for tax purposes as the transaction was not analogous to the securities lending agreement in Rev. Rul. 57-451 and *Anschutz Co. v. Commissioner* where the court found that the transaction eliminated the risk of loss with regard to the lent shares and thus violated the requirements of section 1058(b)(3) according to which a share-lending agreement must not limit a security lender's risk of loss or opportunity for gain. For more on these cases, *see* V. Hammer,*Update on US Taxation Issues*, 12 Derivs. & Fin. Instrums. 5, pp. 142-144 (2010), Journals IBFD.

[211] Cf. subsec. 260(2). For more information on Canadian tax treatment of payments under domestic and cross-border transactions, *see* C. Steeves, *Securities Lending and REPO Transactions: Canadian Income Tax Considerations*, 15 Derivs. & Fin. Instrums. 3, pp. 96-100 (2013), Journals IBFD.

[212] For Danish administrative practices, *see* K. Dyppel, *Beskatning af aktielån og REPO'er*, SR-Skat, 2013, p. 53 et seq.

[213] Such allocation principles often follow from specific rules or case law. The branch reporters to the IFA Congress in 2007 (Kyoto) were asked whether their country attributed income, as a general rule, on the basis of legal or economic entitlement, where legal entitlement was the basis was reported in 20 countries and economic entitlement in 8 countries, cf. J. Wheeler, *The General Report on Conflicts in the attribution of income to a person*, Cahiers de droit fiscal international, 2007, volume 92b, p. 20. Wheeler states, that: '*of course a simple choice between legal and economic entitlement as a basis for attribution cannot do justice to the many nuances and qualifications explained by the branch reporters*', and gives examples of different nuances.

[214] This is especially essential if the ownership is changed for tax avoidance reasons. For considerations on classification of proceeds from the transfer of dividend rights as part of a dividend-stripping arrangement *see* M. Helminen, *supra* n. 1, at pp. 99-106.

and the United Kingdom.[215] In almost all countries dividends are generally allocated to the shareholder, i.e. the owner of the shares.[216] However, deviations exist such as in the Netherlands and Sweden, where dividends are attributed to the person who is entitled to them and in Australia, where dividends are attributed to the person who has the voting power on matters regarding distribution on dividends.[217]

In some countries the allocation and tax treatment of dividends and/or substitute dividend payments under share loan agreements may follow from domestic substance over form or anti-avoidance rules.[218] Such anti-avoidance rules may be applied for the purpose of determining the ownership of the shares and/or the allocation of the dividends or merely for the purpose of imposing withholding taxes.

The US dividend stripping rules are an example of enacted anti-avoidance rules for the purpose of imposing withholding taxes on payments of a "dividend equivalent" or "substitute dividend payments".[219] A substitute dividend payment is a payment made to the transferor of a security in a securities lending transaction or a repo of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction.[220]

For UK tax purposes, short-term ownership of shares is ignored and therefore the dividends paid under share loan agreements are generally allocated to the lender as the long-term owner.[221]

For Danish tax purposes a reimbursement of distributed dividends on the lent shares is taxed as dividends in the hand of the lender if the dividends themselves are merely paid on by the borrower to the lender. Thus, the dividends are also allocated to the lender for Danish tax law purposes. Contrary, in other countries such as Finland, France, Germany, Italy, Ireland, Korea, the Netherlands, Norway and Switzerland the dividends paid under a share loan agreement are generally allocated to the borrower.[222]

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[215] Cf. J. Wheeler, *supra* n. 12, at p. 26. Concerning Germany *see* A. Born, *Impact of Tax Reform 2001 on Stock Lending Transactions*, 5 Derivs. & Fin. Instrums. 1, pp. 27-28 (2003), Journals IBFD; and H. Häuselmann, *Tax Treatment of Domestic Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 2, pp. 73-74 (2001), Journals IBFD; concerning Italy *see* R. Russo, *Tax Treatment of Stock Lending Agreements*, 8 Derivs. & Fin. Instrums. 1, p. 20 (2006) Journals IBFD; concerning New Zealand *see* A. Smith, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 2, p. 87 (2001) Journals IBFD; and concerning Switzerland *see* J. Salom, *The Attribution of Income in Swiss and International Tax Law*, 65 Bull. Intl. Taxn. 7, p. 394 et seq. (2011), Journals IBFD.

[216] Cf. Helminen, *supra* n. 1, at p. 109; and Wheeler, *supra* n. 12, at p. 31.

[217] Cf. Wheeler, *supra* n. 12, at p. 31, where also other exceptions are outlined.

[218] Id. at p. 32.

[219] Cf. section 871(m) in section 541 of the HIRE Act (dividend equivalent) and Treas. Reg. section 1.861-3(a)(6) (substitute dividend payments). For these rules *see,* for example, Blessing, *supra* n. 1, at p. 126 et seq.; P. Carman, *US Dividend Equivalents: Repos and Swaps Subject to Dividend Tax*, 14 Derivs. & Fin. Instrums. 2, pp. 74-80 (2012), Journals IBFD; Flink et al., *supra* n. 5, at p. 52 et seq., Gaffney, *supra* n. 1, at p. 985 et seq., Penn, *supra* n. 1, at pp. 917-933; Shapiro, *supra* n. 9, at p. 188 et seq.; and L.A. Sheppard, *How to Fix Withholding on Securities Loans and Swaps*, Tax Notes International, 2009, pp. 633-636. For a regulatory framework effective as of 1 January 2012 to reduce the possibility of cascading taxes (announced as Notice 2010-46) *see* Gaffney, *supra* n. 1, at p. 986 et seq.

[220] Cf. Treas. Reg. sec. 1.861-3(a)(6). For earlier case law in this regard, *see* Chip, *supra* n. 9, at p. 1061 et seq.

[221] *See* J. Lindsay, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 1, p. 41 (2001), Journals IBFD; and Wheeler, *supra* n. 12, at p. 32.

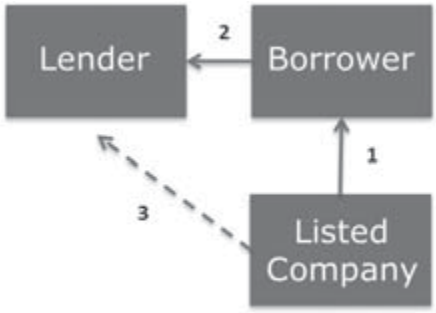
[222] Cf. J. Wheeler, *The General Report on Conflicts in the attribution of income to a person*, Cahiers de droit fiscal international, 2007, volume 92b, p. 32. The Netherlands makes an exception under its treaty with the United States and for that purpose

As briefly illustrated, the allocation of dividends under share loan agreements differs from state to state and depends not only on whether the share loan agreement entails a transfer of ownership but also on the applicable principle of allocation. It follows from the general report to the IFA Congress in 2007 (Kyoto) that all the branch reporters were of the opinion that domestic allocation of outbound income is made without taking allocation principles in other countries into consideration.[223] This may impose a risk of double taxation and double non-taxation if the involved states apply different allocation principles.

4. Qualification of Dividend Related Payments According to the OECD Model

It follows from the above that qualification and allocation according to domestic tax law may differ from state to state. Further, it follows, for the purpose of analysing the tax treatment of the dividend related payments under cross-border share loan agreements, that three income streams are relevant. Compared to Figure 1 illustrating the real cash flows (cash flow 1 and 2), a third cash flow occurs. This cash flow illustrates the relevant income stream if the dividend payment is allocated to the lender. Consequently, the three cash flows illustrated in Figure 2 occur due to different allocation principles under domestic law, i.e. in some jurisdictions cash flow 1 and 2 (the real payments) are relevant, whereas cash flow 3 is relevant in jurisdictions where the dividends are allocated to the lender for tax purposes.

Figure 2: Dividend related payments under share loan agreements for tax purposes



In the following the qualification of the related dividend payments are analysed for treaty purposes. The purpose is to outline the tax treatment of the cash flows under the different allocation principles. As the

regards the lender as the beneficial owner of a dividend, cf. id. Concerning Germany *see*Born, *supra* n. 14, at pp. 27-28; and Häuselmann, *supra* n. 14, at pp. 73-74; concerning Italy *see* Russo, *supra* n. 14, at pp. 19-24; concerning Ireland *see* J. O'Leary, *Tax Treatment of Domestic and Cross-Border Securities Lending Transactions*, 3 Derivs. & Fin. Instrums. 1, pp. 25-30 (2001), Journals IBFD; concerning the Netherlands*see* B. Baldewsing et al., *The Tax Treatment of Stock Lending and REPO Transactions*, 2 Derivs. & Fin. Instrums. 1, pp. 16-19 (2000), Journals IBFD; and J. Smits, *Tax Treatment of Domestic and Cross-Border Stock Lending Transactions*, 9 Derivs. & Fin. Instrums. 6, pp. 203-209 (2007), Journals IBFD.

[223] Cf. Wheeler, *supra* n. 12, at pp. 48-50, in which some exceptions are also mentioned.

tax treaty qualification may depend on the domestic allocation of the income, the analyses are made under the simplified assumption that the relevant states allocate the given cash flow to the same taxable person for domestic tax law purposes. Unless otherwise stated the analyses are based on the 2010 version of OECD Model Tax Convention on Income and on Capital (OECD Model).

4.1. Qualification of cash flow 1

Cash flow 1 is relevant if the dividend payments are allocated to the borrower and constitutes the dividends distributed to the borrower from the listed company, whose shares are subject to the share loan agreement. Firstly, it is relevant to ascertain whether cash flow 1 qualifies as a dividend payment for treaty purposes. If so, it is analysed whether the borrower is the beneficial owner of the dividends in the meaning of the treaty. This question is of relevance as the borrower is obliged to pass the dividends on to the lender under the share loan agreement.

Article 10 of the OECD Model covers dividends paid by a company.[224] The term; "dividends" is defined in article 10(3) on the basis of examples. According to article 10 (3), "dividends" means:

(1) Income from shares (…) or

(2) [Income from] other rights not being debt-claims (…)

(3) As well as income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

The definition in the OECD Model consists of three parts, whereas the first two parts define the term autonomously.[225] The term is not fully and exhaustively defined and it follows from the third part of the definition, that the term must be interpreted in accordance with the laws of the source state. However, if an income fits under the autonomous parts of the dividend definition, domestic law does not affect the classification, as the reference to domestic law under the third part of the definition must be secondary,

[224] For a historical evolution of the definition, *see* J.F. Avery Jones et al., *The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?*, 1 World Tax J. 1, p. 1 (2009), Journals IBFD; J. Hattingh, *South Africa: The* Volkswagen *Case and the Secondary Tax on Companies: Part 2 – The Effect on the Taxation of Dividends with Emphasis on Deemed (Constructive) Dividends*, 63 Bull. Intl. Taxn. 10, pp. 509-533 (2009), Journals IBFD; H. Pijl, *Interest from Hybrid Debts in Tax Treaties*, 65 Bull. Intl. Taxn. 9, pp. 496-502 (2011) Journals IBFD; and J. Sasseville, *The Definition of "Dividends" in the OECD Model Tax Convention* in *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.) IBFD 2012), EC and International Tax Law Series, Vol. 8, p. 70 et seq., Online Books IBFD.

[225] These parts must be interpreted according to the general rule of article 3(2) of the OECD Model, cf. Hattingh, *supra* n. 23, at p. 518; Helminen, *supra* n. 1, at p. 63; Sasseville, *supra* n. 23, at p. 69; and Vogel et al., *Klaus Vogel on Double Taxation Conventions. Kluwer Law International*, 1997, p. 649.

with respect to the conditions in the first and second part of the definition.[226] This follows from the interrelation of the three parts of the definition observed by Vogel, according to which:[227]

The three parts of the definition are not set side by side in a way that would make them independent of one another. The word 'other' used in the second and third parts of the definition constitute a reference to the preceding part or parts, a reference that must not be ignored when reading the definition.

It follows from paragraph 1 in the preliminary remarks of the Commentary on Article 10 of the OECD Model, that "by 'dividends' is generally meant the distribution of profits to shareholders by companies limited by shares". Accordingly, a distribution from a listed company to a shareholder is covered by the term "dividends" for treaty purposes. Therefore – under the given assumptions – the qualification of cash flow 1 should not give rise to any doubt in this regard, i.e. a distribution from the listed company to the borrower (as shareholder) is qualified as dividends for treaty purposes.

According to the OECD Model, the principle of taxation of dividends is not an exclusive right to tax by either of the states. Instead, the right to tax is divided between the contracting states. Thus, the source state may only levy a reduced withholding tax, if the beneficial owner of the dividends is a resident of the other contracting state, whereas the tax so charged depends on whether the participation exemption is met by the beneficial owner, compare article 10(2). Consequently, if the borrower is the beneficial owner of the distributed dividends, the state, in which the distributing company is resident, may only levy a reduced withholding tax. On the other hand, if the borrower is not considered to be the beneficial owner, the source state is not obliged to give up taxing rights over the dividend income, i.e. withholding tax may be levied (without limitations).

In recent years the beneficial owner requirement has been frequently analysed in the literature and subject to case law, as numerous revenue authorities have relied on the concept to challenge, otherwise tax effective, arrangements involving holding companies and other intermediaries.[228] In respect of the beneficial owner requirement in article 10, the question at hand often concerns whether a company,

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[226] *See* Avery Jones et al., *supra* n. 23, at sec. 3.3.; *see* Hattingh *supra* n. 23, at p. 516; and Helminen, *supra* n. 1, at p. 65.
[227] Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Pijl, *supra* n. 23, at p. 490 et seq.
[228] For some recent contributions, *see* P. Baker, *The Meaning of "Beneficial Ownership" as Applied to Dividends under the OECD Model Tax Convention* in *Taxation of Intercompany Dividends under Tax Treaties and EU Law* (G. Maisto (ed.) IBFD 2012), EC and International Tax Law Series, Vol. 8, chapter 6, Online Books IBFD; M. Lang et al. (eds.), *Beneficial Ownership: Recent Trends*, (IBFD 2013), Online Books IBFD; and J. Wheeler in *The Missing Keystone of Income Tax Treaties*, 3 World Tax J. 2, p. 257 et seq. (2011), Journals IBFD; and in *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, pp. 478-488 (2005), Journals IBFD. For an overview of the pending Danish cases on beneficial ownership *see* H.S. Hansen et al., *Danish "Beneficial Owner" Cases – A Status Report*, 67 Bull. Intl. Taxn. 4/5, pp. 192-200 (2013), Journals IBFD; for an Canadian view *see* G. Watson & S. Baum, *International Tax Planning: Beneficial Ownership as a Treaty Anti-Avoidance Tool?*, Canadian Tax Journal, 2012, pp. 149-168; and for a French view *see* B. Gouthière, *Benefical Ownership and Tax Treaties: A French View*, 65 Bull. Intl. Taxn. 4/5, pp. 217-222 (2011), Journals IBFD.

that redistributes a dividend payment to its parent company, is the beneficial owner of the dividends received.

Unlike the traditional cases, the relevant parties (the borrower, the distributing company and the lender) under a share loan agreement may not be connected as a group for tax purposes. Thus, the borrower does not redistribute the dividends to its parent company in a traditional sense. However, if the borrower as the immediate recipient of the dividends is obliged to pass the dividends on to the lender under the share loan agreement, it raises the question whether the borrower is the beneficial owner of the dividends in the meaning of the treaty.

The requirement of beneficial ownership was introduced in articles 10, 11 and 12. The term was added to clarify the meaning of the words "*paid…to a resident*" and thus to make clear that the source state is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a state with which the source state had concluded a double tax convention.[229]

It has been widely discussed whether the term beneficial owner should be interpreted autonomously or whether the term has to be determined from domestic law of the contracting state (lex fori) in accordance with article 3(2) of the OECD Model. However, distinguished scholars agree that the term has an "*international fiscal meaning*" and is not dependent upon the domestic law in either of the contracting states.[230] According to P. Baker, there are several reasons for the use of an international fiscal meaning:

in many countries there is no domestic meaning of the term; where there is such a meaning, it is now clear from the OECD Commentary that a technical meaning is not to be applied; the term is essentially one that has come into tax treaty usage from international tax practice and not from the domestic tax systems of the countries concerned.[231]

However, C.P. du Toit states that if the term forms part of domestic law; there is room to argue that article 3(2) can be applied for the purpose of interpreting the meaning of beneficial ownership itself, i.e. it does not allow recourse to other domestic legal principles, such as domestic anti-abuse law.[232]

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[229] Cf. paragraph 12 of the Commentary on Article 10(2) of the OECD Model.
[230] Cf. Baker, *supra* n. 27, at p. 100; C.P. du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* p. 171 et seq. (IBFD 1999), Online Books IBFD; K. Vogel et al., *supra* n. 24, at p. 562; and Wheeler, *supra* n. 27, at p. 481.
[231] Cf. Baker, *supra* n. 27, at p. 100.
[232] Cf. du Toit, *supra* n. 29, at p. 177 et seq. This reference to domestic law has been taken further by the Netherlands State Secretary for Finance, who has argued that domestic dividend stripping rules also applies in the tax treaty context, irrespective of whether the relevant tax treaty itself limits the benefits of (the dividend article of) the treaty to the beneficial owner. This means that only a person that qualifies as the beneficial owner for dividend stripping purposes is eligible for the benefits of (the dividend article of) the applicable tax treaty, cf. the Netherlands Parliament, Upper Chamber, 2001-2002, 27896-28246, No. 117b, pp. 4-8 and Netherlands Parliament, Lower Chamber, 2000-2001, 27896, No. 3, pp. 2-3 commented by Smits, *supra* n. 21, at p. 207 (2007). According to J. Smits this has been widely criticized in Netherlands tax literature. *See also* the Canadian cases *Prévost* and *Velcro Canada Inc. v. The Queen*, according to which the domestic definition of "beneficial owner" is

It follows from the proposed revised comments to paragraph 12.1 to article 10 of the OECD Model that the term "beneficial owner" should have an autonomous meaning.[233] Further, it is stated that this revised comment should not be viewed as an amendment but as a specification of the existing comment. This remark is based on the guidance in the existing paragraph12 and the majority of the comments received on the issue supporting the conclusion that the term beneficial owner should have an autonomous treaty meaning.[234] Accordingly, this also indicates that the term should be interpreted autonomously.

According to the Commentary on Article 10 of the OECD Model, the term "beneficial owner" should not be used in a narrow, technical sense. Rather, the term should be understood in its context and in light of the object and purpose of the double tax convention.[235] The term is defined in paragraph 12 of the Commentary on Article 10(2) of the OECD Model and it follows from paragraph 12.2 that the borrower is not considered a beneficial owner if he is acting in the capacity of an agent or nominee or is simply acting as a conduit for the lender.[236]

In this regard, it is specified that:

For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation conventions and the Use of Conduit Companies" concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties

Thus, if the immediate recipient has very narrow power in relation to the income concerned and therefore acts as a conduit company; the immediate recipient cannot be regarded as the beneficial owner. Under a share loan agreement, the borrower is obliged to pass on received dividends to the lender and therefore has no power in regard to the income, as the share loan agreement does not attributes the borrower disposal over the distributed dividends. Based on this, it seems that the borrower cannot be regarded as the beneficial owner.

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appropriate when interpreting Canada's tax treaties. These cases are e.g. commented by Watson & Baum, *see supra* n. 27, at pp.149-168.

[233] Cf. OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012.

[234] Cf. paragraphs 2-4 of OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012.

[235] Cf. paragraph 12 of the Commentary on Article 10(2) of the OECD Model.

[236] It follows from OECD's public discussion draft of the revised proposals concerning the meaning of beneficial owner in articles 10, 11 and 12 of the OECD Model as of 19 October 2012 to 15 December 2012, that the expression in paragraph 12 "received by" is amended to "paid direct to" and the expression "immediate" is amended to "direct", i.e. "immediate received by" is amended to "paid direct to".

In October 2012, the OECD released a revised discussion draft on suggested changes to the commentary relating to the meaning of the term "beneficial owner".[237] The proposed paragraph 12.4 is perhaps the most significant attempt to clarify the meaning of the term "beneficial owner", as it clarifies that anything less than a binding obligation to pay the actual payment to another person does not deprive the recipient of beneficial ownership.[238] The revised proposal explains that any obligation to pass the payment received to another person "must be related to the payment received" and "would therefore not include contractual or legal obligations unrelated to the payment received even if those obligations could effectively result in the recipient using the payment received to satisfy those obligations".[239] Accordingly, the mere fact that the immediate recipient passes on received dividends to fulfill contractual or legal obligations does not solely preclude that the immediate recipient is considered the beneficial owner, as the obligation to pass on the received dividends must be related to the dividends received. The proposed commentaries laid down in the revised discussion draft therefore suggest a narrow scope of the beneficial ownership requirement in order to prevent that a number of legitimate situations do not fulfil the beneficial ownership requirement and thus, are not be covered by the reduced withholding taxes on dividends.

As the borrower's obligation under a share loan agreement is a legal obligation to pay the actual payment to the lender and this obligation is in fact related to the dividends received, an adoption of the amended commentaries outlined in the revised discussion draft does not change the initial conclusion. Thus, under the given assumptions, the borrower may not be regarded as beneficial owner of the distributed dividends illustrated as cash flow 1, as the borrower has a binding obligation to pass on the received dividends to the lender.

Consequently, the real payment made from the listed company, whose shares are subject to the share loan agreement, to the borrower (cash flow 1) qualifies as a dividend payment covered by article 10 of the OECD Model. However, if the borrower is obliged to pass on the received dividends to the lender under the share loan agreement, the borrower (as shareholder) may not qualify as the beneficial owner of the dividends in the meaning of the treaty. Whether the lender (as beneficial owner) is granted treaty benefits (i.e. reduced withholding tax on dividends) may depend on the applicable principle of allocation in the residence states of the parties and whether these states have entered into a double tax treaty. This is further analysed in regard to Scenario 2 and 3 in sections 5.2. and 5.3. of this article.

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[237] Cf. OECD Model: Revised Proposal Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12, 19 October 2012 to 15 December 2012.
[238] Cf. Baker, *supra* n. 27, at p. 93. *See also* M. Lang et al. (eds.), *supra* n. 27, at p. 3.
[239] Cf. Revised proposed Commentary on Article 10, paragraph 12.4 in OECD Model: Revised Proposal Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12, 19 October 2012 to 15 December 2012, *see* http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.

4.2. Qualification of cash flow 2

Cash flow 2 is relevant if the dividends are allocated to the borrower and constitutes the actual payment from the borrower to the lender under a share loan agreement. The payment from the borrower to the lender constitutes a reimbursement of the gross dividends paid on the shares or an amount equal to the net dividends distributed during the term of the loan. In either case, the payment constitutes a substitute dividend payment. As the payment mirrors an actual dividend payment, it raises the question of whether the income may arise from a corporate right and thus, be covered by the term "dividend" in article 10 of the OECD Model.

From the wording "*income from other corporate rights which is subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident*" in Article 10(3), it can be drawn that for treaty purposes only such items of income can be considered "dividends" that arise from corporate rights.[240] The requirement of a corporate right must be interpreted autonomously and therefore the fact that the source state taxes the distribution as dividends under domestic law does not qualify the income as a dividend for treaty purposes.[241]

The term *corporate rights* is not expressly defined in the OECD Model and the term is primarily used to distinguish dividend constituting equity investments from other kinds of investments in a company.[242] In this regard Vogel and Lehner have argued that the context of the treaty indicates that corporate rights must entitle the owner, not only to a share in the current profit, but also, at least, to a share in the liquidation proceeds of the company.[243] Helminen argues that income from a corporate right is income that is received because of a person's position as a shareholder or because of a comparable relationship to a company.[244] Thus, she does not consider access to liquidation proceeds as a dividend requirement. Hattingh argues that the absence of a right to a share in future liquidation proceeds would not preclude a person from holding the necessary corporate right, as he generally considers the content of a corporate right as being the yield of capital risked as an investment in a company.[245] Pijl argues that there is no convincing support for the requirement that the instrument should be entitled to unfettered profit rights, nor that the instrument should be based on company law.[246] Regardless of the delimitation of the substance of the term "corporate right", it seems clear that the income must originate from a corporate right. Further, there also seems to be a general consensus that corporate rights refer to rights under an instrument issued by or at least agreed to by the corporation itself and not a third-party contract in reference to shares of the corporation.[247]

The lender's entitlement to get reimbursed for distributed dividends for the duration of a share loan agreement derives from the specific terms of the share loan agreement entered into between the lender and the borrower. Therefore, even though the substitute payment is based on the amount of the

distributed dividends on the transferred shares, the substitute payment, in and of itself, is not income from corporate rights.[248] In other words, the fact that the substitute payment mirrors the dividends paid by the listed company to the borrower does not make the lender's rights under a share loan agreement into corporate rights. Consequently, the entitlement to the substitute dividend payment does not derive from corporate rights. Instead, the right is based on a lending agreement. Therefore the payment does not qualify as dividends under the OECD Model, even though the payment might be taxed as a dividend in the source state.[249]

It follows from the methodology of the OECD Model that unless income is subject to one of the specific provisions outlined in articles 6 to 20 of the treaty, the income is considered "other income" covered by article 21. It seems reasonable to conclude, that cash flow 2 qualifies as other income under article 21 of the OECD Model unless the lender trades securities in the course of its regular business, i.e. then the payment may qualify as business profits under article 7 of the OECD Model.[250]

4.3. Qualification of cash flow 3

Cash flow 3 in Figure 2 illustrates the relevant cash flow, in the case where the dividend payments are allocated to the lender for tax purposes. Thus, for domestic tax purposes, the payment constitutes a dividend payment from the listed company to the lender, as the lender in this scenario is considered the shareholder and/or the rightful recipient of the dividend income. This raises the question of whether cash flow 3 can constitute *income from shares* covered by the term "dividend" in article 10(1) of the

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[240] Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Hattingh *supra* n. 23, at p. 518; and Helminen, *supra* n. 1, at pp. 64-65.
[241] Cf. Vogel et al., *supra* n. 24, at p. 650. *See also* S. Bärsch, *Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in and International and Cross-Border Context*, Springer, 2012, p. 99 et seq.; Hattingh *supra* n. 23, at p. 518; Helminen, *supra* n. 1, at pp. 102 and 175; and Pijl, *supra* n. 23,at p. 489 et seq.
[242] *See*, for example, J.F. Avery Jones et al., *supra* n. 23, at p. 1 et seq.; J. Bundgaard, *Perpetual and Super-Maturity Debt Instruments in International Tax Law*, 10 Derivs. & Fin. Instrums. 4, p. 139 et seq. (2008), Journals IBFD; J. Bundgaard & K. Dyppel, *Profit Participation Loans in International Tax Law*, Intertax, 2010, p. 657 et seq.; Helminen, *supra* n. 1, at p. 80; Pijl, *supra* n. 23, at pp. 482-502; and Vogel et al., *supra* n. 24, at p. 650.
[243] Cf. K.Vogel et al., *supra* n. 24, at p. 651.
[244] Cf. M. Helminen, *supra* n. 1, at p. 96.
[245] Cf. Hattingh, *supra* n. 23, at p. 519.
[246] Cf. Pijl, *supra* n. 23, at p. 489.
[247] Cf. Blessing, *supra* n. 1, at p. 128; Avery Jones et al., *supra* n. 23, at sec. 3.2.; and Pijl, *supra*. n. 23, at p. 493.
[248] *See also* Helminen, *supra* n. 1, at p. 113.
[249] Id. at pp. 111-112; Smits, *supra* n. 21, at p. 208; and Blessing, *supra* n. 1, at p. 128. Substitute payment may qualify as a dividend under tax treaties, if the substitute payments are treated as a dividend under the domestic law of the payer or if the wording of the dividend definition does not require a dividend to be income from corporate rights, e.g. treaties that follow the US Model or treaties with similar wording. Under the US Model, any income that is taxed the same way as a dividend in the source state qualifies as a dividend. Thus, if the state of residence of the paying company treats the distribution as dividend under domestic law, the income also qualifies as a dividend under the US Model. Another deviation from the OECD Model is the Nordic multilateral treaty according to which any income paid by a company treated in the source state as dividend also qualifies as a dividend for treaty purposes, cf. paragraphs 1 and 6 of article 10 of the treaty. *See*, for these and other specific treaties, M. Helminen, *supra* n. 1, at p. 102 and Blessing, *supra* n. 1, at p. 128.
[250] *See also* Helminen, *supra* n. 1, at pp. 110-111. However, if the lender is considered the beneficial owner of the dividends distributed as cash flow 1, cash flow 2 may constitute a dividend payment for treaty purposes. Thus, the lender may claim the treaty benefits under article 10 of the OECD Model and would thus be eligible for the relief or exemption under article 10 of the OECD Model. *See also* Blessing, *supra* n. 1, at p. 129 et seq., This is further discussed in section 5.2.

OECD Model and consequently be classified as a dividend payment for treaty purposes when the real payments made are cash flow 1 and 2.

As briefly mentioned above, in some jurisdictions share loan agreements are classified as a loan in kind, i.e. the lender is still the legal owner of the shares and in other jurisdictions the share loan agreement is considered a sale of the transferred shares. The allocation of the dividend payment to the lender may follow from general domestic principles of attribution or anti-avoidance legislation. Accordingly, the dividend payment can be allocated to the lender as shareholder of the transferred shares or due to a principle of economic entitlement.

According to paragraph 3 of the Commentary on Article 10 of the OECD Model, the term "dividends" generally means distribution of profits to its shareholders as return on the capital which has been made available to a company by its shareholders. The wording of the commentaries indicates that income based on a dividend right, but paid to a person other than the shareholder, does not qualify as a dividend within the meaning of the definition. As the OECD Model does not explicitly require that a dividend is received by a shareholder, it may be argued that income received by another person than a shareholder may qualify as a dividend payment for treaty purposes. However, the individual parts of article 10(3) of the OECD Model must be interpreted with respect to the whole definition, as the wording "other" used in the second and third parts of the definition constitute a reference to the preceding part or parts.[251] Thus, the wording "as well as income from *other* corporate rights" in the third part of the definition indicates that "*income from shares"* in the first part also must originate from a "*corporate right"*.[252] Based on this, income qualifying as "*income from shares"* must be paid to a shareholder, as a corporate right to income from shares generally follows from shareholding. Accordingly, scholars have argued that dividend treatment requires that the income recipient be a shareholder at least at a certain point prior to the distribution so that the distribution may be said to be made by virtue of a shareholding.[253] However, others have argued that a shareholder requirement is not decisive for an income to qualify as a dividend covered by article 10 of the OECD Model.[254]

For the purposes of qualifying cash flow 3 under the share loan agreement for tax treaty purposes; a "shareholder requirement" gives rise to a distinction between situations in which the income is allocated to the lender as shareholder of the transferred shares and situations in which the allocation is based on

[251] Cf. Vogel et al., *supra* n. 24, at p. 649. *See also* Avery Jones et al., *supra* n. 23, at sec. 3.3.; and Hattingh, *supra* n. 23, at p. 517 et seq.
[252] *See also* Pijl, *supra* n. 23, at p. 490 et seq. For similar considerations and summaries of case law concerning deemed or constructive dividends or hidden profit distributions *see* Hattingh, *supra* n. 23, p. 521 et seq., at p. 532.
[253] *See* Helminen, *supra* n. 1, at p. 101 and Vogel et al., *supra* n. 24, at p. 653.
[254] *See*, for example, Pijl, *supra* n. 23, at p. 493.

other principles; such as economic entitlement or anti-avoidance legislation, i.e. situations in which the lender is not considered shareholder of the transferred shares.[255]

If the source state considers the lender as shareholder for domestic tax purposes, the income is considered a payment made by the distributing company to a shareholder and must, consequently, be qualified as a dividend for treaty purposes. Based on the same arguments as presented in section 4.1., the lender must be considered the beneficial owner of the dividends in this scenario.

On the other hand; if the source state considers the borrower as shareholder but allocates the income to the lender, based on principles such as economic entitlement, substance-over-form or (other) anti-avoidance principles, the shareholder requirement is not met. In other words, if the wording "income from shares" is strictly interpreted and a shareholder requirement is upheld, a substitute dividend payment allocated to another recipient than the shareholder is not considered "income from shares". Further, based on the same arguments as presented in section 4.2., the income cannot be considered income from corporate rights, if the entitlement to the dividend payment follows from a share loan agreement entered into between other parties than the distributing company. Consequently, if the source state considers the borrower as shareholder but allocates the income to the lender based on economic entitlement of the income – substance-over-form or (other) anti-avoidance principles – cash flow 3 may not be considered a dividend covered by article 10 of the OECD Model.

The Commentary on Article 10(3) of the OECD Model seems to have no legal basis themselves to import a substance-based notion of the concept of a dividend into the treat definition[256] Therefore, to apply domestic substance-over-form or anti-avoidance principles for treaty purposes and, thus, (re)classify the income as dividend, it seems to require that such domestic substance-over-form or anti-avoidance principles are respected for tax treaty purposes.[257]

Generally, it follows from the commentaries to the OECD Model that domestic anti-abuse rules do not conflict with treaties.[258] However, the commentaries do not clearly make a distinction between general and specific anti-abuse rules and it is not obvious that domestic anti-abuse rules should be respected for treaty purposes regardless of whether the anti-abuse rule is applied for the purpose of (re)classifying income on a general basis or only to hinder abuse.[259] In any event the effect of domestic

[255] If the ownership of the shares is determined under an anti-avoidance rule, the dividends are still considered as allocated to the lender as shareholder of the transferred shares.
[256] Cf. Hattingh, *supra* n. 23, at p. 520. *See also* S. van Weeghel in *The General Report* in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, 2010, volume 95a, p. 33 et seq.
[257] The approach should be allowed at least with respect to treaties expressly allowing the use of domestic anti-avoidance provisions, cf. Helminen, *supra* n. 1, at p. 112. For variations of the third part of the definition, *see* Avery Jones et al. *supra* n. 23, at sec. 3.4.
[258] Cf. paragraph 22 of the Commentary on Article 1 of the OECD Model.
[259] For the relationship between the domestic anti-avoidance provisions and tax treaties *see* paragraphs 9(1) and 22 of the Commentary on Article 1 of the OECD Model. The commentaries concludes that domestic anti-abuse rules do not conflict with

(re)characterizations for treaty purposes seems to depend on whether the relevant term is defined in the treaty.[260]

Consequently, the tax treaty qualification of cash flow 3 may depend on whether the domestic allocation to the lender is based on the lender's ownership of the transferred shares or principles such as economic entitlement, substance-over-form or (other) anti-avoidance, i.e. situations where the lender is not considered a shareholder of the transferred shares.

If the source state considers the lender as shareholder for domestic tax purposes, cash flow 3 qualifies as a dividend for treaty purposes. If the source state considers the borrower as shareholder for domestic tax purposes and (re) allocates the income to the lender based on anti-avoidance principles, it seems fair to conclude that the income cannot be considered a dividend covered by article 10 of the OECD Model, as the income cannot qualify as a *corporate right*. As a result, the income must be qualified as other income under article 21 of the OECD Model and is therefore subject to the same tax treatment as cash flow 2 analysed in section 4.2. above.

5. Allocation Conflicts

The qualification and tax treatment of the three cash flows illustrated in Figure 2 have been analysed for tax treaty purposes. These analyses are made under the assumption that the involved states have allocated the payment to the same person for tax purposes.

However, the allocation of dividend- related payments under share loan agreements differs from state to state and depends not only on whether the share loan agreement entails a transfer of ownership but also on the applicable principle of allocation. In general, income is allocated to a taxable person for domestic tax law purposes before the relevant treaty is applied, as the treaty generally does not deal with allocation of income.[261]

Some argue that this initial domestic allocation results from the absence of an explicit allocation concept in the treaty whereas others argue that the treaty is not applicable until the income is allocated in accordance with domestic law.[262] Regardless of the argument, this may, obviously, give rise to allocation

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treaties, without clearly making a distinction between general and specific anti-abuse rules. *See also* the reports to the IFA Congress in 2010 (Rome) on *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, 2010, volume 95a.

[260] Cf. van Weeghel, *supra* n. 55, at p. 33 et seq.

[261] Cf. D. Kleist, *Methods for Elimination of Double Taxation under Double Tax Treaties – with Particular Reference to the Application of Double Tax Treaties in Sweden*, Iustus Förlag, 2012, p. 126; Salom, *supra* n. 14., at p. 399; and Wheeler, *supra* n. 27, at pp. 478-488. It follows from the general report to the IFA Congress in 2007 (Kyoto) that also in practice most of the countries apply domestic allocation principles for treaty purposes; cf. Wheeler, *supra* n. 12, at p. 49. However, exemptions are mentioned including Italy, Luxembourg and Portugal who applies the same allocation principles as the resident states for treaty purposes, id. at p. 49.

[262] *See*, for example, Wheeler *supra* n. 27.

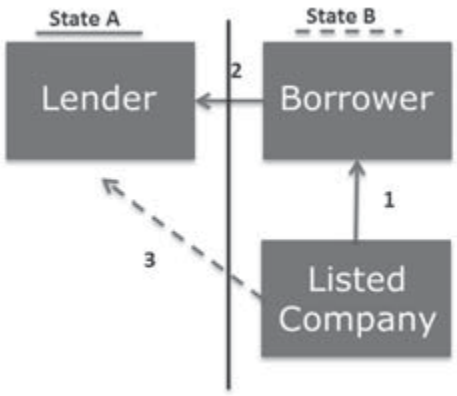
conflicts in cross border transactions, if the domestic allocation in the relevant states differs and the treaty does not deal with the allocation of the income.[263]

In this section the tax implications of allocation conflicts occurring in respect to dividend-related payments under share loan agreements are analysed on the basis of constructed scenarios. In the constructed scenarios it is assumed that the income is allocated to the rightful income recipient based on the ownership of the shares, i.e. the substitute dividends payment is allocated to the shareholder.[264]

5.1. Scenario 1: Different domestic allocation results in a qualification conflict

The first constructed allocation conflict is Scenario 1 as illustrated in Figure 3. In this scenario State A allocates the dividend payment under a share loan agreement to the borrower and, thus; in State A the real payment, i.e. cash flow 2 is the relevant income for treaty purposes. On the other hand, State B allocates the dividend payment to the lender and, thus; in State B cash flow 3 is relevant for treaty purposes.

Figure 3: Scenario 1



Accordingly, both State A and B consider the lender as the rightful recipient of the relevant income for treaty purposes, whereas State A considers the borrower as the payer and State B considers the listed company as the payer. Based on the analysis carried out in section 4. of this article, State A may qualify the relevant income as other income under article 21 of the OECD Model whereas State B may qualify the relevant income as dividends under article 10 of the OECD Model. Consequently, a reduced withholding tax may be levied by State B. In this scenario the tax consequences of a qualification conflict occurring as a spill-over effect of the different domestic allocations of the payments (by State A and State B) is analysed.

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[263] As noted by Wheeler, it might have been expected that more attention would have been paid to this issue, cf. Wheeler, *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, p. 478 et seq. (2005), Journals IBFD.
[264] In this case it makes no difference whether the ownership of the shares follows specific legislation, a general principle of law or anti-avoidance rules.

The scope and reference to the domestic laws of the contracting states in article 3(2) is widely discussed.[265] However, since the OECD changed the Commentary on Article 23 of the OECD Model in 2000, the residence state must grant relief where the provisions of the convention, as interpreted and applied by the source state in accordance with article 3(2) of the OECD Model, authorizes taxation of an item of income by the source state, irrespective of how the income is characterized according to domestic law of the residence state.[266] Article 23 should not be used as a toll for conflicts of qualification in the first place as such conflicts primarily should be solved by the autonomous interpretation in accordance with the provisions of the convention. Further, article 23 can only solve conflicts that are based on different provisions of domestic law and not conflicts of qualification (that are) based on a different interpretation of facts or a different interpretation of the provisions of the convention.[267] Consequently, if and only if – in accordance with article 3(2) and article 10 – the income is characterized as dividends in State B (the source state), State A (the domicile state) must grant relief for withheld taxes. Based on this it should be considered whether State B has characterized the substitute dividend payment as dividends in accordance with article 3(2) and article 10 under this constructed scenario.

In this constructed scenario it is assumed that State B allocates the substitute dividend payment to the lender as the rightful income recipient based on the ownership of the shares, i.e. the lender is considered shareholder according to domestic law in State B. As concluded in section 4.3.; if the source state considers the lender as shareholder for domestic tax purposes, the income is considered a payment made by the listed company to its shareholder and, thus; the income must qualify as a dividend covered by article 10 of the OECD Model for treaty purposes. As article 21 of the OECD Model only applies to items of income not dealt with in the foregoing articles, State A (the resident state) must grant relief as State B (the source state) has levied withholding tax in accordance with articles 3(2) and 10 of the OECD Model.

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[265] For this discussion *see* for example J.F. Avery Jones et al., *Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization*, 36 Eur. Taxn. 4, p. 133 et seq. (1996), Journals IBFD; L. De Broe, *International Tax Planning and Prevention of Abuse*, Doctoral Series, volume 14, p. 262 et seq. (IBFD 2008), Online Books IBFD; F. Engelen, *Interpretation of Tax Treaties under International Law*, Doctoral Series, volume 7, chapter 10.10 (IBFD 2004), Online Books IBFD; A.R. Huerta in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, pp. 19-38; J.F. Avery Jones, *The Interaction between Tax Treaty Provisions and Domestic Law* in *Tax Treaties and Domestic Law* (G. Maisto (ed.) IBFD 2006), paragraph 6.2, Online Books IBFD; J. Schwarz, *Schwarz on Tax Treaties*, CCH, Wolters Kluwer, 2011, second edition, p. 90 et seq.; and N. Shelton, *Interpretation and Application of Tax Treaties*, Tottel publishing, 2004, p. 196 et seq. For this discussion with specific regards to the definition of dividends *see*, for example J.F. Avery Jones et al., *Whether the Definition of Dividend Limited to the Dividend Article Applies to the Double Taxation Relief Article Granting Underlying Credit*, 53 Bull. Intl. Taxn. 3, pp. 103-108 (1999), Journals IBFD.

[266] Cf. paragraphs 32.1 and 32.2 of the Commentary on Article 23A and 23B of the OECD Model. *See also* Engelen, *supra* n. 64, at sec. 10.10; Huerta, *supra* n. 64, at p. 29 et seq., Avery Jones, *supra* n. 64, at para. 6.2; S. Kienberger in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, pp. 309-332; P. Martin, *Interaction between Tax Treaties and Domestic Law* , 65 Bull. Intl. Taxn. 4/5, pp. 205-210 (2011), Journals IBFD; and Sasseville, *supra* n. 23, at p. 70.

[267] Cf. paragraphs 32.4 and 32.5 of the Commentary on Articles 23A and 23B of the OECD Model.

If, on the other hand, State B (the source state) considers the borrower as shareholder for domestic tax purposes and (re) allocates the income to the lender based on economic entitlement, substance-over-form or (other) anti-avoidance principles the income may not be considered a dividend covered by article 10 of the OECD Model.[268] As a result, the income may qualify as other income under article 21 of the OECD Model, i.e. State B is not given the right to levy any withholding taxes.

As concluded in section 4.3., the tax treaty qualification of cash flow 3 may depend on whether the domestic allocation in the source state is based on ownership of the shares or economic entitlement of the income, substance-over-form or (other) domestic anti-avoidance provisions and whether the contracting states accepts domestic anti-avoidance provisions for treaty purposes. Consequently, if State B – in accordance with articles 3(2) and 10 – considers the income as dividends in State B (the source state), State A (the domicile state) must grant relief for withheld taxes, compare article 23 of the OECD Model. If, on the other hand, the domestic allocation in State B (the source state) is based on domestic anti-avoidance provisions not accepted for treaty purposes, State A (the domicile state) may not be obliged to grant relief for withheld taxes, compare article 23 of the OECD Model.

The distinction between the different situations may not always be clear and therefore, in practice, the qualification conflict may be based on different interpretations of facts or different interpretations of the provisions of the convention, which are conflicts that cannot be solved by applying article 23 of the OECD Model. As a result, in this scenario the income received by the lender may be subject to double taxation and consequently double non-taxation.[269]

5.2. Scenario 2: Different domestic allocation results in two relevant tax subjects

In the second constructed scenario, the border and the allocation according to domestic tax law has been amended as illustrated in Figure 4. Under this scenario State A allocates the dividend payment to the lender and consequently; in State A cash flow 3 is the relevant income for treaty purposes. On the other hand, State B allocates the dividend payment to the borrower and, thus, in State B the real distribution, i.e. cash flow 1 is the relevant income for treaty purposes.

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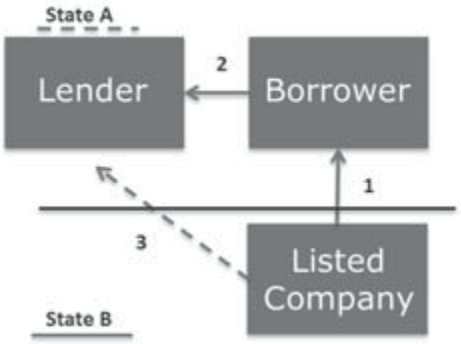
[268] *See* section 4.3.

[269] In order to avoid double taxation based on classification conflicts, Helminen suggests not to tax substitute dividend payments as a dividend under tax treaties, which follows the wording of the OECD Model and proposes that, if contracting states wish to treat a substitute dividend as a dividend for tax treaty purposes, such treatment should expressly be mentioned in the tax treaty, cf. Helminen, *supra* n. 1, at p. 112. The treaty entered into between the Netherlands and the United States includes a special article on share loan agreements. According to Netherlands domestic tax law, substitute dividend payments are not treated as dividends and consequently no domestic credit is granted for withheld foreign taxes. However, according to the treaty entered into with the United States, the payments are treated as dividends paid directly by the distributing company to the lender and are subject to the applicable withholding tax rate under the treaty, thus, domestic credit is granted. This provision is analysed in Smits, *supra* n. 21, at p. 203. *See also* Avi-Yonah & Swartz, *supra* n. 5, at p. 798.

Figure 4: Scenario 2



In this scenario the different domestic allocation principles, applied in State A and State B, result in a situation in which both states consider State B as the source state, whereas State A considers the lender as the rightful income recipient and State B considers the borrower as the rightful income recipient.

Based on the analysis carried out in section 4. of this article, State A will presumably qualify the substitute dividend payment as dividends under article 10 of the OECD Model received by the lender. Therefore, a relief for withheld tax may be granted.[270] As the lender is considered the beneficial owner for treaty purposes; State A may only grant limited credit for withheld tax, as State A considers the source state (State B) subject to the limitation of tax according to article 10 of the OECD Model.

Based on the analysis carried out in section 4. of this article, State B may also qualify the payment as a dividend payment covered by article 10 of the OECD Model, but instead, the borrower is considered the rightful income recipient. However, the lender – and not the borrower – is considered the beneficial owner of the distributed dividends for treaty purposes.

Accordingly, State A and State B have applied different domestic allocation principles but it is assumed that both states consider the lender as the beneficial owner of the dividend payment. In this scenario it is analysed whether treaty benefits may be granted, i.e. whether the beneficial owner requirement in article 10(2) may solve the risk of double taxation that occurs due to this allocation conflict. This imposed risk of double taxation occurs if State B levies withholding taxes without limitations (i.e. if the condition for the limitation of tax in the source state is not considered fulfilled) and State A only grants a limited relief.

The general scope of the comprehension of the beneficial owner provision is that the provision is not an allocation rule.[271] It is argued that, before applying a treaty, the source state should first ascertain

[270] *See* section 4.3.
[271] *See,* for example, V.K. Gupta in E. Burgstaller & K. Haslinger (eds.), *Conflicts of Qualification in Tax Treaty Law*, Linde, 2007, p. 56.

whether or not the income is paid to a person resident in the other contracting state.[272] Only then, does the source state verify whether the person, to whom the income is allocated to, is the beneficial owner. Therefore, the beneficial owner requirement cannot be applied as an allocation principle for the purpose of reducing the risk of double taxation.

If the borrower is not the beneficial owner and therefore cannot claim treaty benefits in respect of the dividend income under article 10 of the OECD Model, it raises the question; can the beneficial owner, i.e. the lender can claim treaty benefits and thus be eligible for the relief or exemption under article 10 of the OECD Model.[273] If so, this may solve the risk of double taxation occurring due to the allocation conflict.

In the constructed Scenario 2 the lender and the borrower are both resident in State A which has entered into a treaty with the resident state of the listed company (State B). Therefore, the limitation of tax in State B remains available, as it follows from the wording of article 10(2) of the OECD Model that:

…if the beneficial owner of the dividends is a resident of the other Contracting State [than the Contracting State of which the company paying the dividends is a resident], the tax so charged shall not exceed….

The wording of this paragraph was amended on 21 September 1995 by replacing the words "*if the recipient is the beneficial owner the dividends*" with "*if the beneficial owner of the dividends is a resident of the Contracting State*". It follows from the amended wording that it is no longer a requirement that the immediate recipient is the beneficial owner but only a requirement that the beneficial owner is a resident of the contracting state.[274] Thus, as both the lender and the borrower are resident in State A, the listed company is obliged to levy reduced withholding taxes as the lender (as beneficial owner) is granted treaty benefits.

In this regard it should not be decisive that the lender may not be considered the owner of the shares for domestic tax purposes in State B (the source state), as the beneficial ownership requirement in article 10 of the OECD Model, presumably, must be concerned with the right to the income flow and not the right to the shares.[275] In other words, the qualification of the income as dividends covered by article 10 of the OECD Model should not be influenced by the fact that the lender as beneficial owner is not considered owner of the shares according to which the dividends are distributed. This seems to follow

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[272] *See* Salom, *supra* n. 14, at p. 400. *See also* J. Wheeler, *The Missing Keystone of Income Tax Treaties*, 3 World Tax J. 2, p. 257 et seq. (2011), Journals IBFD, who states that it is not clear, whether the beneficial ownership requirement is a substantive attribution rule or an anti-avoidance rule.
[273] This question is also raised by Wheeler, *see supra* n. 12, at p. 41.
[274] This also follows from paragraph 12.2 of the Commentary on Article 10(2) of the OECD Model.
[275] Cf. Baker, *supra* n. 27, at p. 95. *See also* J. Wheeler, *The Attribution of Income to a Person for Tax Treaty Purposes*, 59 Bull. Intl. Taxn. 11, p. 479 et seq. (2005), Journals IBFD, for an outline of the different arguments.

from the nature of the beneficial ownership requirement. This also follows from the *Royal Dutch* case[276] according to which it is possible to be the beneficial owner of dividends, even though the recipients do not own the shares themselves. Consequently, in this situation, the income can be considered a dividend payment received by the lender as beneficial owner.

It follows from paragraph 12.2 of the Commentary on Article 10(2), that the amended wording in 1995 was to clarify what was already the consistent position of all member countries. However, even though this amendment, presumably, was merely a clarification, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner, if the wording of the treaty follows an earlier version of the model. Thus, the current wording and the clarifying comments may reduce the risk of double taxation but the risk of double taxation remains in practice.[277]

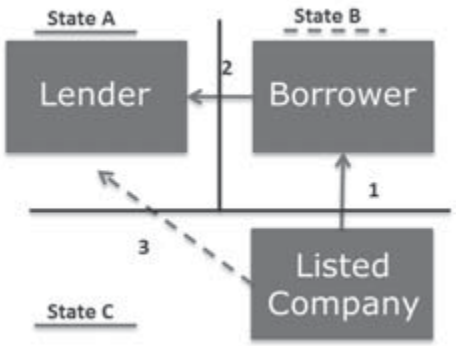
In this scenario, State A and State B have applied different domestic allocation principles – allocating the distributed dividends to the lender and the borrower respectively. Based on the assumption that both states consider the lender as beneficial owner of the dividend payment, the imposed risk of double taxation occurring due to this allocation conflict, should be eliminated under treaties following the wording of the 1995 version of the OECD double tax convention, as treaty benefits should be granted "*if the beneficial owner of the dividends is a resident of the Contracting State*". However, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner, if the wording of the treaty follows an earlier version of the model, i.e. a risk of double taxation remains in practice.

5.3. Scenario 3: Different domestic allocation results in multiple applicable treaties

In the final and third constructed scenario, State C is added. State A and B allocate the income as in Scenario 1. Therefore, in Scenario 3 State A allocates the dividend payment to the borrower making the real payment, i.e. cash flow 2 relevant for treaty purposes. State B allocates the dividend payment to the lender and thus, the payment is not relevant for neither domestic nor treaty purposes, as State B considers the payment made between the listed company resident in State C and the lender resident in State A. State C allocates the income to the borrower, therefore, cash flow 1 is relevant for treaty purposes in State C. Scenario 3 is illustrated in Figure 5.

[276] Cf. BNB 1994/217 also referred to as the "*Market Marker*" case.
[277] *See* under Scenario 3 for an example of a double tax risk.

Figure 5: Scenario 3



Based on the analysis carried out in section 4. of this article, State A may qualify the dividend payment under as other income under article 21 of the OECD Model and therefore the payment is not eligible for relief in State A according to the treaty. As the income is not relevant for tax purposes in State B, no withholding tax is levied on cash flow 2 and the borrower is not granted any relief for withholding taxes levied by State C on cash flow 1. Based on the analysis carried out in section 4. of this article, State C may qualify the payment as dividend paid to the borrower covered by article 10 of the OECD Model. As the lender – and not the borrower – is considered the beneficial owner of the distributed dividends for treaty purposes, the condition for the limitation of tax in State C is not fulfilled. Thus, according to the treaty entered into between State B and State C, State C may not be restricted to withhold tax.

Accordingly, in this scenario the different domestic allocation principles applied in State A, B and C may result in a situation where State C levies withholding taxes on the dividends paid immediately to the borrower, whereas neither State A nor B grant any relief for the paid tax. In Scenario 2 it is analysed whether treaty benefits may be granted, i.e. whether the beneficial owner requirement in article 10(2) may solve the risk of double taxation that occurs due to this allocation conflict. Unlike in Scenario 2 this scenario is based on a share loan agreement involving three treaty states.

It follows from paragraph 12.2 of the Commentary on Article 10(2) of the OECD Model that:

subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State....

Accordingly, the beneficial owner can claim treaty benefits in respect of the dividend income under article 10 of the OECD Model and thus be eligible for the relief or exemption under article 10 of the OECD Model, if the resident state of the beneficial owner and the original source state have entered into a treaty – even though the intermediate company is resident in a third state.

As mentioned under Scenario 2 in section 5.2., the wording of article 10 was amended in 1995 to clarify what was already the consistent position of all member countries. However, even though this amended wording should also apply when interpreting the consequences of the beneficial owner requirement in treaties following the wording of a version of the OECD Model older than 1995, it is not obvious that all OECD Member States will grant relief or exemption under article 10, when the immediate recipient is not the beneficial owner. Also situations in which the original source state acknowledges that the beneficial owner should be granted treaty benefits, it is not clear under what circumstances these benefits are granted. As an example, withholding taxes on dividends paid from Denmark as the original source state are, presumably, only reduced if:[278]

- The income received by the beneficial owner is identical to the value of the income paid from the original source state to the intermediate company.

- The income received by the beneficial owner has the same character as the income paid by the original source state to the intermediate company, i.e. the income must not change character (e.g. be repaid to the beneficial owner as interests) as the income should be subject to the same tax treatment in the resident country of the beneficial owner as if the income was paid directly from the original source state to the beneficial owner.

- The income is received by the beneficial owner and taxed in the same taxable income year as the payment to the intermediate company is made.

However, in one case the Danish tax authorities have decided on the applicability of treaties in respect to share loan agreements and decided that the applicable treaty is the one entered into between the resident state of the distributing company and the resident state of the lender.[279]

It should be noted, that these requirements follow from administrative case law concerning a traditional beneficial ownership issue and is therefore merely included for the purpose of illustrating the issues and some of the practical uncertainties that still exist even though the wording of article 10 of the OECD Model was amended (and clarified) in 1995. The tax implications in respect to beneficial ownership seem to differ from state to state, which is also illustrated in the general report to the IFA Congress in 2007 (Kyoto).[280]

[278] Cf. SKM 2011.441 SR (Administrative case).
[279] Cf. TfS 2010.454 SR.
[280] Cf. Wheeler, *supra* n. 12, at p. 36 et seq.

This scenario may result in a situation in which the resident state of the lender (State A) acknowledges the immediate allocation of income to the borrower and, therefore, the lender may not be granted relief for withholding taxes levied by the original source state (State C); but only for withholding taxes imposed by the intermediate state (State B). If neither the beneficial owner nor the intermediate company is granted relief for tax withheld by the original source state, a double tax situation occurs. Accordingly, in this scenario the different domestic allocation principles applied in State A, B and C may result in a situation where State C levies withholding taxes on the dividends paid immediately to the borrower, whereas neither State A nor B grant any relief for the paid tax.

Based on the assumption that all states consider the lender as beneficial owner of the dividend payment, the imposed risk of double taxation occurring due to this allocation conflict, should be reduced under treaties following the wording of the 1995 version of the OECD double tax convention, if the resident state of the beneficial owner and the original source state have entered into a treaty – even though the intermediate company is resident in a third state. However, from a source state perspective, it may still be subject to uncertainty under what circumstances the beneficial owner in practice can claim treaty benefits, when the immediate recipient is not the beneficial owner and, from a resident state perspective, it may still be subject to uncertainty under what circumstances the intermediate company and/or the beneficial owner in practice is granted relief for withholding taxes.

6. Conclusion

The purpose of this article is to identify and analyse some of the qualification and allocation challenges that the dividend related payments under share loan agreements give rise to for tax treaty purposes. It has been shown that different domestic allocations of dividends under share loan agreements may impose a risk of double taxation and double non-taxation, as the allocation of outbound income generally is made without taking allocation principles in other countries into consideration.

None of the articles in the OECD Model deals specifically with qualification of payments made under share loan agreements. Further, the OECD Model generally does not deal with allocation of income. Thus, on the basis of three constructed scenarios, it is illustrated how the different domestic allocations of the dividends under share loan agreements can result in a qualification conflict for treaty purposes; a situation in which two tax subjects are relevant for the treaty purposes and a situation in which multiple treaties may apply.

The main challenges identified in this article concern the questions: to what extent payments made under a share loan agreement may be covered by the term “dividends” in article 10 of the OECD double tax convention and to what extent the lender in a share loan agreement fulfil the beneficial ownership requirement and thus, is granted treaty benefits. The answers to these questions seem to depend on

whether the income is allocated to the (legal or economic) owner of the transferred shares for domestic tax purposes of whether the income is allocated to another person than the shareholder of the transferred shares based on economic entitlement, substance-over-form or (other) anti-avoidance principles.

Based on the analysis carried out in this article it can be concluded, that treaties following the wording of the 1995 version of article 10 of the OECD double tax convention may grant the beneficial owner treaty benefits and thereby eliminating any risk of double taxation. Further, if a qualification conflict occurs as a spill-over effect of the different domestic allocations of the payments article 23 of the OECD Model can eliminate the risk of double taxation if, and only if, in accordance with article 3(2) and article 10 – the income is characterized as dividends in the source state. However, for many reasons it is not obvious that all OECD Member States will grant relief or exemption under articles 10 and 23. The risk of double taxation and double non-taxation cannot be eliminated by applying the ordinary articles in the OECD Model. Thus, unless the treaty deals specifically with the qualification of payments made under share loan agreements or allocation conflicts, this risk remains.

Chapter 6 – The participation exemption: Tax-free synthetic interest in companies[281]

Petter Bjerksund, Professor[282], Gunnar Stensland, Professor[283] & Ingebjørg Vamråk, Research Scholar[284]

Abstract

It is well known from financial theory that certain combinations of shares and/or equity derivatives are a source of synthetic interest income. For a Norwegian corporation that has such positions, the synthetic interest income will be tax-exempt as a result of the participation exemption[285]. This means that in principal, the corporation achieves additional returns compared to a bank deposit. In this paper the authors will shed further light on this issue, and discuss possible solutions.

1. Introduction

As a general rule, investment income, such as interest, dividends and gains from the sale of capital assets represents taxable income. However, the so-called participation exemption regime provides an exception from tax liability on typical equity earnings in the corporate sector. The participation exemption is intended to prevent multiple taxation of income from equity investments. [286] In Norway it was decided to allow income from shares, i.e. both dividends and capital gains, as well as income from equity derivatives to be tax exempt under the participation exemption regime.[287]

The purpose of this article is to point out and highlight a tax loophole that seems to be overlooked in the relevant literature[288] regarding the introduction of the Norwegian participation exemption and the shareholder model[289]. We show that a corporation that owns shares, and uses equity derivatives to manage its risk, can achieve a synthetic interest income that is tax exempt for the corporation under the participation exemption. Furthermore, we show that synthetic interest income can be achieved by the use of equity derivatives even though the corporation does not own shares.

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[282] Department of Business and Management Science, Norwegian School of Economics (NHH).
[283] Department of Business and Management Science, Norwegian School of Economics (NHH).
[284] Department of Accounting, Auditing and Law, Norwegian School of Economics (NHH).

[285] The participation exemption implies that dividends or capital gains derived from qualifying holdings are tax exempt when received by intermediate companies, i.e. distributed within the corporate sphere, cf. the Norwegian tax code section 2-38.
[286] See, in particular, ot.prp. nr. 1 (2004–2005), p. 52ff.
[287] With effect from 2008, the tax exemption is limited to 97% of income from equities and equity derivatives. In this article, for simplicity, we have assumed 100% tax exemption. See the tax code section 2-38 6th subsection letter a.
[288] Sørensen (2005) p. 796, NOU (Norwegian official reports) 2003:9 attachment 1, Ot.prp. nr. 1 (2004-2005).
[289] The *shareholder model* is the commonly used name of the set of rules that applies to stock income earned by personal taxpayers. See the tax code section 10-11 to section 10-13.

This means that the corporation can achieve a higher return compared to depositing money in the bank or to investing in fixed interest debt securities. This extra return comes at the expense of society in the form of lost tax revenue. In our opinion, the problem can only to a limited extent be dealt with by the application of the Norwegian general anti-avoidance doctrine or by limiting the participation exemption to income from shares.

2. Point of departure

2.1 The distinction between debt and equity

In Norwegian law, income taxation of interest and dividends has traditionally been determined based on the legal form of the instrument from which the income is derived. For tax purposes, whether the income is derived from a debt or an equity instrument is determined by the instrument's most prominent characteristics.[290]

In tax law, the central difference between debt and equity is that a debt instrument has a predetermined repayment date contracted between the lender and borrower. There is no repayment right/obligation related to equity. This reflects the risk of losing the invested principal amount; an equity capital contribution has what is often referred to as "loss-absorbing capacity".

Another important difference between equity and debt is related to returns. Typical for the debt instrument is the yield (interest rate) agreed between the parties in advance, and that the obligation to pay/right to receive this is unconditional. The returns on equity (dividends), however, are typically not agreed in advance, and are conditional on, among other things, corporation profits and corporate decisions to pay dividends.

2.2 Synthetic interest

By synthetic interest income we mean current, virtually risk-free income that derives from a position that could be construed as a loan. A simple example would be as follows: A corporation purchases shares today for NOK100 million. At the same time, the corporation enters into a forward contract to sell the shares for NOK105 million with settlement in 12 months. For the corporation, this aggregate position has the same characteristics as a loan: The corporation invests NOK100 million today and will receive a fixed amount (NOK105 million) at a predetermined time (in 12 months). For the corporation, this entails a risk-free return that is agreed in advance. We can interpret the income of NOK5 million as *synthetic interest*.[291]

[290] This follows from a longstanding precedent. See, in particular, Rt. 2001 s. 851.
[291] Because of the role of the clearing-house, the risk of not getting the settlement as agreed is almost zero.

The problem we call attention to is that because of the participation exemption, companies have an incentive to choose alternatives where the taxable income achieves classification as equity income – as in the above example – rather than classification as debt income. In other words, the scheme leads to the situation where typical debt instruments are less attractive than alternatives that provide similar economic reality, and which are covered by the participation exemption.

The purpose of the participation exemption was not to favour the asset class shares at the expense of the asset class debt instruments, but to avoid multiple taxation of the income from equity investments. In addition to detecting the different aspects of the problem through the use of examples, we therefore consider whether we can see solutions that can help avoid this unintended incentive to invest in shares.

3. Synthetic interest when the taxpayer owns shares

In the following two sections we show some examples of how different combinations of shares and/or equity derivatives result in synthetic interest which is basically tax-free for the corporation.

Example A: Risk management using a forward contract

Consider a corporation that owns equities. As part of its risk management, suppose the corporation wants to reduce its risk exposure to shares by NOK 100 million for a shorter or longer period, for example one year.

One alternative is to sell the shares for NOK100 million and deposit the money into a bank account, with the aim that this amount including return is invested in shares at a later date. Assume an interest rate of 5%. The bank deposit provides a return of NOK5 million. With 27% in tax, in one year the corporation will have NOK103.65 million available, which can be invested in shares (table 1). The risk-free rate of return after tax is thus 3.65%.

Table 1: Bank deposit

Value (NOK million):	*period 0*	*period 1*
Bank deposit	100	*100 + 5*
– Tax (27%)		–1.35
= *Bank deposit after tax*	100	103.65

Another alternative is to retain the shares to be secured and instead, reduce risk by way of an equity derivative. For simplicity, we shall assume that the shares do not pay dividends the following year. The

current value of the shares to be secured is NOK100 million, while the value of these shares in one year's time, NOK S_1 million, is uncertain viewed from today. Suppose now that the corporation enters into a forward contract for the sale of the shares with settlement in one year (table 2). The value of the contract today is null, while the agreed payment for the shares in one year is NOK105million.[292] The value of the contract in one year's time thus corresponds to the difference between the agreed payment and the value of the shares in a year, i.e. NOK $(105 - S_1)$ million. We assume that the forward contract is settled financially, i.e. that the net gain/loss on the contract is settled in cash. This means that in one year's time, the corporation owns shares of NOK S_1 million as well as a receivable/payable amount of NOK $(105 - S_1)$ million, i.e. financial assets totalling NOK105 million. This implies a risk-free return of 5% for the period.

Table 2: Retain shares and enter into a forward contract

Value (NOK million.):	*period 0*	*period 1*
Shares	100	S_1
+ Sell shares on settlement date	0	$105 - S_1$
= Synthetic bank deposit	100	105

We can interpret the corporation's overall position in table 2 as a synthetic bank deposit and the returns as synthetic interest income. The participation exemption implies that the corporation has tax exemption for income from shares and the equity derivative, such that the transactions have basically no tax implications for the corporation. This means that when the corporation uses a forward contract to reduce risk in its investment portfolio, the corporation simultaneously achieves a risk-free rate of return after tax that is higher than the corporation can achieve by depositing money in the bank. [293]

[292] The forward price of 105 can be explained as the current equity value of 100 carried forward with the interest rate of 5%, i.e. 105 = 100 * (1+5%). See, for example, Hull (2012) p. 104.

[293] As a result of the shareholder model (see footnote 5) some of this extra return of NOK1.35 million could become taxable as ordinary income in the personal shareholder's hands. Assume that the corporation's shares correspond to a shielding basis of NOK100 million with a private shareholder and the shielding interest rate (post-tax risk-free rate) is 3.65%. If the corporation sells the shares and deposits the money in the bank, NOK3.65 million can be distributed as tax-free dividends. If the corporation retains the shares and reduces the risk with equity derivatives, NOK5 million can be distributed as dividends. The excess dividend return of 5-100*3.65% = NOK1.35 million will be taxed at 27%, so the dividend after tax will be 5-1.35*27% = NOK4.6355 million. At the same time, this example illustrates that the shareholder model does not close the tax loophole covered in this article.

Example B: Risk management using a total return swap

Now let us extend the example above to include a longer period (*T* years). We assume bonds with annual interest payments due in year *T* that currently trade at face value, and shares paying an annual dividend. Current income, start and end value of having NOK100million invested respectively in interest-bearing bonds and shares are shown in table 3 where NOK D_t million is paid out as dividend in year t, $t = 1, \cdots, T$, and NOK S_T million is the value of the shares in year *T*.

Table 3: Investment respectively in bonds and shares in *T* periods

Value /current income (NOK mill.)	*Start value*	*Current income/final value*		
	period 0	*period 1*	*...*	*period T*
Bonds	100	5	...	5 + 100
Shares	100	D_1	...	$D_T + S_T$

Consider a corporation that owns shares. Suppose, as part of its risk management, the corporation wants to reduce its risk exposure to shares by NOK100 million for a longer period of time –for example T years.

An alternative is to sell the shares for NOK 100 million and invest the amount in bonds, with a view to investing in shares later (table 4). The annual interest income from the bonds is taxed at 27%, so the interest paid after tax is NOK 3.65 million per year. The final value of the bonds corresponds to the start value so that the transaction does not trigger capital gains tax for the corporation on the horizon. Upon redemption, the corporation thus receives NOK100 million, which can then be invested in shares. In this case, the corporation achieves a risk-free rate of return after tax of 3.65% per year.

Table 4: Investment in bonds

Value/current income (NOK mill.)	*Start value* *period 0*	*Current income/final value* *period 1*	...	*period T*
Bonds	100	5	...	5 + 100
– Tax (27%)		–1.35	...	–1.35
= Bonds after tax	100	3.65	...	3.65 + 100

Suppose now that the corporation is able to enter into a total return swap with a nominal NOK100 million and duration *T* years. This represents a contract where the corporation relinquishes the return from investing NOK100 million in shares in the period and receives the return from investing the same amount in interest-bearing bonds. Returns for each of the instruments consist of current income and estimated gains/losses on the horizon. The value of this contract is null today and gives the corporation a current income as shown in table 5, where NOK $(5-D_t)$ million is the difference between annual interest payment and annual dividend, while NOK (S_T-100) million is the capital gain/loss on the underlying shares for the period.

Table 5: Investment respectively in bonds, shares and total return swap in *T* periods

Value/current income (NOK mill.)	*Start value* *period 0*	*Current income/final value* *period1*	...	*period T*
Bonds:	100	5	...	5 + 100
* return (1)		5	...	5 + (100–100)
Shares:	100	D_1	...	$D_T + S_T$
* return (2)		D_1	...	$D_T + (S_T - 100)$
Total return swap (1) – (2)	0	$5 - D_1$	...	$5 - D_T - (S_T - 100)$

Another option for the corporation is then to retain the shares to be secured and instead reduce risk by using an equity derivative until time *T*. The current value of the shares to be secured is NOK100 million, dividend in year *t* is NOK D_t million, and the value of the shares on the horizon is NOK S_T million. Further assume that the corporation enters into a total return swap where the corporation switches equity returns (annual dividends and capital gain/loss for the period) at an annual interest rate of return, cf. table 5, above. We assume that the contract is calculated annually and is settled financially. By combining the shares to be secured with a suchlike equity derivative, the corporation achieves an annual risk-free current income of NOK5million (table 6). On the horizon, the calculated capital gain/loss on the contract's underlying shares is settled. This means that on the horizon, the corporation owns shares of NOK S_T million and an asset/liability of NOK $(100 - S_T)$ million. In total, this represents financial value of NOK100million. Thus, the corporation achieves a risk-free return of 5 % per year.

Table 6: Retain shares and enter into a total return swap

Value/current income (NOK mill.)	*Start value*	*Current income/final value*		
	period 0	*period 1*	*...*	*period T*
Shares	100	D_1	...	$D_T + S_T$
+ Total return swap	0	$5 - D_1$	...	$5 - D_T - (S_T - 100)$
= Synthetic bond	100	5	...	5 + 100

We can interpret the overall position in table 6 as a synthetic bond and the return as synthetic interest. The participation exemption implies that the corporation has tax exemption for income from the shares and from the equity derivative[294], such that the transactions have basically no tax implications for the corporation. This means that when the corporation uses a total return swap to reduce risk in its investment portfolio, the corporation simultaneously achieves a risk-free rate of return after tax that is higher than the corporation can achieve by investing in fixed income securities.

[294] Cf. statement "Equity swap in relation to the participation exemption" from the Ministry of Finance dated 29.06.2005.

4. Synthetic interest without the taxpayer owning shares

Above we have shown examples of how a corporation that owns shares and that uses equity derivatives to reduce risk in its investment portfolio, at the same time achieves a synthetic interest income which is basically tax exempt. In the following we show that synthetic interest can come into being in the derivative market without the corporation even owning shares.

Example C: Combination of forward contracts with different delivery prices

Suppose bonds that do not pay coupon interest and have redemption at period 2, and shares that pay dividends at period 1 and period 2. Further assume three forward contracts on shares with settlement at period 2 and with different delivery prices to be paid upon delivery. The settlement of the contracts can be either physical (delivery of shares and payment of the agreed price) or financial (net settlement). In the example, the market forward price is 105 (current market value of this contract is null). Thus, the current market value of a contract with a delivery price that is lower (higher) than 105 will be positive (negative). We assume that a potential positive/negative market value is paid/received in cash upon signing the contract. Table 7 shows the initial value, current income and final value of the instruments in question.

Table 7: Investment respectively in bonds, shares and three forward contracts

Value	*Start value*	*Current income/final value*	
	period 0	*Period 1*	*period 2*
Bonds	100		110.25
Shares	100	D_1	$S_2 + D_2$
Buy forward at delivery price 100.59	4		$S_2 - 100.59$
Buy forward at delivery price 105	0		$S_2 - 105$
Buy forward at delivery price 111.615	-6		$S_2 - 111.615$

If the corporation invests in bonds, the realized interest return of 10.25% during the two-year period will be taxed at 27%.

Suppose now that the corporation buys shares forward at the lowest delivery price. The corporation must prepay 4 at the start of this contract and is obligated to pay 100.59 when the shares are received.

Further assume that the corporation *sells* the same shares forward at the highest delivery price. The corporation must prepay 6 at the start of this contract and will receive 111.615 upon delivery of the shares. Table 8 shows the position this gives the corporation.

Table 8: Buying and selling forward

Value	*Start value* *period 0*	*Final value* *period 2*
Buy shares forward at delivery price 100.59 + Sell shares forward at delivery price 111.615	4 6	$S_2 - 100.59$ $111.615 - S_2$
= Synthetic bond	10	11.025

We can interpret the overall position in table 8 as a synthetic bond and the risk-free return of 10.25% (= (11.025 – 10)/10) during the two-year period as a synthetic interest rate. The participation exemption implies that the corporation basically has tax exemption for income from equity derivatives.

What is needed to achieve a synthetic interest is to combine contracts for the same shares with the same settlement date but with different delivery prices. The strategy is to buy forward at low delivery price and sell forward at high delivery price. In the example there are three forward contracts and thus three pair combinations (strategies) which give similar results. The essential point in this example is that the discount/premium in the delivery prices is balanced at period 0, i.e. when entering into the contract.

In principle, it is possible to create synthetic forward contracts using options, which in turn can be combined as shown in the examples above. A variation is to use the *put-call parity* known from option pricing theory: A synthetic forward purchase of shares can be achieved by entering into a buy option (call) for the shares and simultaneously issuing a sell option (put) for the shares with the same strike price and expiry date. A synthetic forward sale of the shares can be achieved by taking the opposite positions. The corporation can achieve the same position as in table 8 as follows: Enter into a call option and issue a put option both with strike price 100.59, and simultaneously issue a call option and enter into a put option both with strike price 111.615.

Another variant is to exploit the fact that an option with very high exercise probability (deep in-the-money) gives approximately the same future payment as a forward contract. A call option with a very

low strike price represents an approximate forward purchase of shares at a very low delivery price. Suppose that the corporation simultaneously enters into the deep in-the-money call option and a forward sale of shares at the market forward price. The corporation will then achieve a virtually risk-free future payment that amounts to the difference between the market forward price and the very low strike price. [295] The cost of this strategy today is the call option premium.

A put option with a very high strike price represents an approximate forward sale of shares at a very high delivery price. Suppose that the corporation simultaneously enters into a forward purchase of shares at the market forward price and the deep in-the-money put option. The corporation will then achieve a virtually risk-free future payment that amounts to the difference between the very high strike price and the market forward price. [296] The cost of this strategy today is the put option premium.

5. Tax law assessment

Equity derivatives are financial contracts of which character is derived from stocks. Concerning which derivatives are included in the participation exemption, the preparatory works states that "crucial to whether the participation exemption is applicable will be whether the gain or loss on the underlying shareholding would have been covered by the participation exemption, if the ownership had been realized at the time the gain or loss on the derivative is realized."[297]

An equity derivative is a financial contract of which the return is determined by the return on one or more shares. In the above examples we have seen that different combinations of shares and/or equity derivatives provide a total return that is *risk-free* and *detached* from equity returns. It is obvious that a financial contract with such a financial reality (loan) would not be considered an equity derivative in relation to the participation exemption, and as such, that income (interest) would be taxed as capital income according to ordinary rules. The central tax law question is whether positions in equities and/or equity derivatives are within the scope of the non-statutory general anti-avoidance doctrine, when the correlated positions create a financial reality that does not have the character as derived from shares.

The Norwegian tax general anti-avoidance doctrine is generally described as a rule consisting of two requirements which both must be met in order for the doctrine to apply: Pursuant to the *basic* requirement the main purpose of the transaction must have been to save tax. And pursuant to the *second* requirement taxation on the basis of the transaction as it appears must be deemed to conflict with the

295 Should the shares be worth less than the very low strike price of the call option, the corporation will receive a higher future payment.
296 Should the shares be worth more than the very high strike price of the put option, the corporation will receive a higher future payment.
297 Translated from Ot.prp. No. 1 (2004-2005) paragraph 6.5.2.4.

object and purpose of the otherwise applicable tax rule(s).[298] A major issue concerning the second requirement is whether there is a sufficient business purpose behind the transaction, which is normally a matter of establishing the extent of *commercial inherent value*[299] (business purpose) of the transaction; if there is sufficient business purpose behind the chosen transaction the anti-avoidance doctrine does not apply. There is no such threshold as 50% or other. Probably far less than 50% business purpose is sufficient to render the doctrine inapplicable.[300]

In examples A and B, the need for risk management is the taxpayer's primary goal behind the transactions. However, it is possible to achieve the same by selling shares and buying bonds. But the buying and selling of shares and bonds is costly; it incurs fees to brokers and other transaction costs, such as bid-ask spread. Moreover, the taxpayer will normally lose both dividend and voting rights on the shares if he sells the shares to buy a bond.

Given that rational actors would have chosen the derivative alternative even though the tax rules treat both alternatives equally, the primary purpose of the transaction cannot have been to save taxes. Thus, the basic condition of the general anti-avoidance doctrine is not met, and it is not necessary to decide whether the additional condition is met.

All the same, it is natural to mention the potential importance of dividends and voting rights, in that the inherent value of the transaction is the most important aspect in the assessment of the second requirement. The most prominent aspects of ownership of shares are normally the dividends and the voting rights. Thus a most natural assumption is that the more short-lived the ownership of the shares, the less inherent value is represented in ownership. It is nevertheless conceivable that the specific timing of the brief ownership implies a certain inherentc value. It is, for example, possible to imagine that an actual utilization of the voting right may affect the assessment.

In example C, it is difficult to see any rational purpose beyond saving tax: When the starting position is that the taxpayer does not own shares, there is no risk to manage, and no transaction costs to reduce. It is also difficult to see that the positioning means that the taxpayer speculates on his own market view. Therefore, the probable motive behind this kind of positioning is solely to convert ordinary equity income to tax-free interest income. In such cases, the basic condition of the general anti-avoidance doctrine could probably be considered as met.

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[298] The GAAR was first time expressed as consisting of these two requirements in Rt. 2002 p. 456 Hydro Canada.
[299] The term *inherent value* was introduced by K. Kvisli, and acknowledged by the Norwegian Supreme Court in Rt. 1966 p. 1189 (Vestlandske Vassdrag)
[300] See, for instance, Rt. 1997 p. 1580 (Zenith), even though not the most representative case.

It is not inconceivable that a positioning as in example C will also be considered not to have sufficient business purpose to stay clear of the anti-avoidance doctrine. The purpose of the exemption from taxation that the participation exemption provides is that, to avoid multiple taxation of the income from equity investments, only equity income is to be covered by the tax exemption. Ergo, applying the general anti-avoidance doctrine, with taxation of income such as interest – could potentially be the result.

What concerns the second requirement the Supreme Court in a ruling of March 2014 concluded that the anti-avoidance doctrine was not applicable to the taxpayer's customization of transactions in order to make a certain income tax exempt under the participation exemption regime. The court in particular held that the legislator has been fully aware of the tax planning opportunity in question, and still has chosen not to adopt rules that could prevent it from being taken advantage of. [301] Then, the court held, the court should not apply the anti-avoidance doctrine, especially the taxpayer's need for legal certainty taken into consideration.

If to compare to our example C, such tax saving alternatives are far from as well-known as the tax saving alternative present in the court case referred to above. Allowing the most creative and relatively unknown customizing alternatives to stay clear of the anti-avoidance doctrine would easily imply the favouring of the taxpayers who have sufficient resources to spend on tax planning, at the expense of society in the form of lost tax revenue. Hence, it is not inconceivable that a breach of the principle of equality between taxpayers could be a good reason for applying the anti-avoidance doctrine to an arrangement such as the one in our example C. This, in particular, as the principle of legal certainty would not be particularly challenged in such a case.

On the other hand, the following general starting point expressed in the ruling pulls in the opposite direction: "Viewed apart, it obviously conflicts with the purpose of the general capital gain taxation rule if the oil corporation's gain is not taxed. However, this is with no relevance because the purpose of the participation exemption regime in fact *is* to make such gains tax exempt." [302] Consequently it seems very hard to predict what would be the result if our example C or a similar case was brought before Supreme Court.

In summary, the rule of thumb probably is that when the purpose of the specific choice of transaction alternative has been risk management, speculation or reduction in transaction costs, the basic condition in the anti-avoidance doctrine is normally not met.

[301] Rt. 2014 p. 227 (ConocoPhilips). For the specific statements referred to here, see section 66.
[302] See section 53.

Our examples are, however, simplified with the intention of clearly presenting the purest of motives and course of events. An example of a significant simplification we have assumed is that it is clear what financial realities a taxpayer's positions represent. But before avoidance can be assessed, extensive effort is usually needed to ascertain the situation. This becomes even more complicated as equity derivatives are often settled financially (net settlement) and there is then no demonstrable correlation in time between the settlement of the derivative and the potential realization of the underlying shares.

Furthermore, we have assumed a clear relationship between the returns from equity derivatives and shares. Suppose now that the corporation has a share portfolio with a composition similar to the OBX index.[303] A combination of this equity portfolio and the sale of an OBX index forward contract will give the corporation a virtually risk-free interest income. How much must the composition of the corporation's equity portfolio differ from the OBX index for the transaction to have sufficient "commercial intrinsic value" for tax purposes?

6. Tax on equity derivatives?

Suppose now that the tax exemption for income from equity derivatives was repealed and that gains and losses are treated symmetrically. Let us first go back to table 2 in example A above, where the corporation which offloaded share price risk with a forward contract achieved a synthetic tax-free return. With tax on the return from the forward contract, the corporation must take a somewhat stronger position in this contract, i.e. $\frac{1}{1-0.27}$ instead of 1, to achieve the desired risk relief.

Table 9: Retain the shares and enter into a forward contract – with taxable equity derivative

Value (NOK mill.)	*Start value* *Period 0*	*Final value* *period 1*
Shares + Sell $\frac{1}{1-0.27}$ shares forward	100 0	S_1 $(105 - S_1) \cdot \frac{1}{1-0.27}$
= Synthetic bank deposit before derivative tax – Tax (27%) on forward returns	100	$S_1 + (105 - S_1) \cdot \frac{1}{1-0.27}$ $-(105 - S_1) \cdot \frac{0,27}{1-0.27}$

303 The OBX index lists the 25 most liquid companies that are traded on the Oslo Stock Exchange. In the market, both futures and options are traded on this index.

= Synthetic bank deposit after derivative tax	100	105

By comparing table 9 with table 2, we see that even with the introduction of tax on income from equity derivatives, the corporation achieves the same risk-free position. This means that even if the participation exemption is restricted to only include income from shares, it will still be possible for the corporation to achieve a tax-free synthetic interest return. It can be shown that the same applies in example B above.

Finally, let us consider example C. In this example, we showed that the corporation can achieve a synthetic interest return by combining forward contracts. With tax on returns from equity derivatives, we must expand table 8 above, and the return will be as shown in table 10.

Table 10: Buying and selling forward – with tax on equity derivatives

Value (NOK mill.)	*Start value* *period 0*	*Final value* *period 2*
Buy shares forward at delivery price 100.59 + Sell shares forward at delivery price 111.615	4 6	$S_2 - 100.59$ $111.615 - S_2$
= Synthetic investment before derivative tax – Tax (27%) on forward at delivery price 100.59 – Tax (27%) on forward at delivery price 111.615	10	11.025 $-(S_2 - 100.59 - 4)\cdot 0.27$ $-(111.615 - S_2 - 6)\cdot 0.27$
= Synthetic investment after derivative tax	10	$11.025 - 1.025 \cdot 0.27$

We see from table 10 that the realized two-year return before tax of 10.25% from the synthetic investment is now taxed in the same manner as interest returns from a two-year bank deposit.

The examples illustrate that the problems are not necessarily eliminated by limiting the participation exemption to stock income.

7. Conclusion

The Norwegian participation exemption, with different tax treatment of equity and interest income, allows for tax arbitrage. In our opinion, the problem can, only to a limited extent, be dealt with by the application of the general anti-avoidance doctrine or by limiting the participation exemption to income from shares. We see no simple solutions to the tax loophole that is pointed out in this article. There is good reason to believe that the problem will persist as long as the participation exemption is retained.

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Chapter 7 - Equal taxation as a basis for classifying financial instruments as debt or equity – a Swedish case study

Axel Hilling[304] and Anders Vilhelmsson[305]

Abstract

This chapter examines the way in which classification of financial instruments as debt or equity has developed in the Swedish income taxation system over the past 25 years. Although the structure of the tax system is based on the assumption that debt instruments are financial instruments with low risk, the legal development has not shared that assumption, resulting in several types of high-risk derivative instruments being covered by the definition of legal debt. This chapter illustrates how that development, which can be recognized in most income-tax systems within OECD countries, seriously threatens the fundament of the tax system: equal taxation for capital income and income from labor. The chapter concludes by illustrating how the standard solution to the problem of classifying financial instruments as debt and equity – by treating them alike – does not fulfill the challenged principle of equal taxation, but actually intensifies the development towards unequal taxation.

Keywords: Debt, Equity, Derivatives, Income tax, Flat tax, Financial theory, Swedish tax law, Horizontal equity

1. Introduction

1.1. Equal or effective income taxation?

Although the history of tax planning with intercompany interest deductions dates back at least 30 years in Sweden, it was not until 2009[306] that it was considered such a serious threat to the tax base that Sweden introduced legal measures to prevent it.[307] These legal measures were triggered when tax audits on Swedish multinational enterprises indicated an annual base erosion of approximately SEK 25 billion.[308] Two additional investigations by the Tax Agency revealed inefficiency in the 2009 limitation rules, resulting in the launch of second-generation limitation rules on interest deductions in 2013.[309]

Since first introduced in 2009, the anti-avoidance rules have been heavily criticized for their vagueness, and even for being in conflict with the EU Treaty.[310] Consequently, the Swedish Committee on Corporate

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[304] Associate Professor in Business Law, Knut Wicksell Centre for Financial Studies, Lund University School of Economics and Management. Editor-in-chief of the *Nordic Tax Journal*

[305] Associate Professor in Business Administration, Knut Wicksell Centre for Financial Studies, Lund University School of Economics and Management

[306] Prop. 2008/09:65.

[307] Hilling, A. (2012) p. 313–315.

[308] Swedish Tax Agency (2008).

[309] Swedish Tax Agency (2009) and (2011); Prop. 2012/13:1. See also Swedish Tax Agency (2014).

[310] See Section 5.3.1.

Taxation (*Företagsskattekommittén*) was given the assignment of presenting new regulations that could replace the criticized rules. In June 2014, the Committee proposed a new corporate income tax system that involved extensive limitation rules on interest deductions.[311]

Outside Sweden, *base erosion and profit shifting (BEPS) – the process of moving profits to a lower-tax jurisdiction* – have been addressed by the Organisation of Economic Co-operation and Development (OECD) and the European Commission. In their high-profile projects, the main purpose of which is to facilitate the drafting of tax law that makes it possible for their member countries to tax income generated within their borders, anti-avoidance rules on companies' interest deductions are essential.[312]

In national and international efforts to find methods that make it possible to tax production where it is conducted, the focus is on corporate income taxation. The theoretical basis for such new tax models as the comprehensive business income tax (CBIT), and allowance for corporate equity (ACE) are based predominantly on economic research focusing on the way different tax rules affect the behavior of multinational enterprises.[313] New models to meet the challenges of base erosion and profit shifting involve equal treatment of debt and equity to the highest possible extent. According to relevant theory, such treatment will make the corporate income tax systems more effective, compared to a situation in which debt and equity are treated differently.[314]

The theories encouraging equal treatment of debt and equity are far from new – a noteworthy fact in the OECD's ongoing BEPS project. The most fundamental of these principles can be traced back many decades.[315] Thus the financial/economic theories on which new tax systems are founded are generally much older than most tax systems, such as the Swedish system of 1990, which are now subject to major makeovers. This idiosyncrasy raises the following question: Why did the tax legislators not rely on these theories when today's tax system was designed? More specifically, why did the tax legislators not treat debt and equity alike when designing the tax systems that are now being overhauled?

When the current Swedish income tax system was designed, the corporate income tax system was expressly perceived as an integrated part of the taxation of individual earnings from capital investments.[316] Consequently, the perspective differed from the current one, focusing as it did on the taxation of company owners rather than companies. Consequently, goals for effective corporate income

[311] SOU 2014:40. For a presentation of the proposal, see Lodin, S-O (2014).
[312] OECD (2013) and COM (2012) 722 final.
[313] See especially Auerbach, A. J., Devereux, M. P., and Simpson, H. (2010), and de Mooij R.A. and Devereux M. P. (2011). The dominance of economic literature, in relation to legal ditto, is conspicuous in the proposal of the Swedish Committee on Corporate Taxation, see SOU 2014:40, pp. 85–120.
[314] de Mooij, R.A. (2011) pp. 9–12.
[315] See e.g. Seligman, E.R.A. (1925) pp. 271–315, and Modigliani, F. and Miller M. H. (1958).
[316] SOU 1989:34, part I, pp. 207–215, and Prop. 1989/90:110, pp. 514–519.

taxation had to be balanced against other goals of the income tax system – equal taxation of individuals, for example.

As for the Swedish taxation of income from capital, the preparatory works to the 1990 tax reform required *horizontal equity: not only shall capital income be taxed the same as income from labor but equal tax shall apply to the various types of capital income*.[317] The principle of horizontal equity had a strong status at the time the income tax system was drafted and has seriously influenced the structure of the system.[318] Consequently, Swedish corporate income taxation was initially structured as an integrated part of the entire income tax system, the overall goal of which was to tax income equally at the individual level.

Because of the foundation of today's tax system in the principle of horizontal equity and because corporate income taxation is structured as an integrated part of a system, tax legislators' arguments in favor of new corporate income taxation is open to criticism. Treating corporate income taxation in isolation from the rest of the tax system clearly challenges the purposes of horizontal equity, which is a fundament of the system and triggers the question of whether tax legislators now find it more important to support effective corporate income taxation than to support equal income taxation for individuals. It also triggers the question of whether it is possible to maintain equal taxation and still defend the corporate tax base from international tax planning.

We have found no evidence that the Swedish tax legislators have announced a shift in preference of their tax law policy from equal taxation to effective corporate income taxation. Furthermore, debt and equity financing and multinational enterprises existed prior 1990, and were apparently not considered an insoluble obstacle for equal taxation when the 1990 tax system was constructed. Consequently, there must be another reason for shifting the focus from equal to effective taxation.

We argue in this chapter that it is the tax legislators' inability to classify new financial instrument as debt or equity properly that has forced them to abandon equal taxation. More specifically, it is the legal distinction between debt instruments and derivative instruments that constitutes the seemingly irresolvable classification issue.

1.2. Purpose

The legal distinction between debt and equity has been subject to extensive doctrinal discussions in Europe and North America.[319] In most cases, the international challenge – the challenge for open

[317] Prop. 1989/90:110, pp. 296, 304–305, 388 and SOU 1989:33, part I pp. 60–72.
[318] SOU 1989:33, part I pp. 49–56. About horizontal equity, see e.g. Holmes, K. (2000) pp. 19–21.
[319] See Pratt, K. (2000), Schoen, W. (2009), Brown, P. (2012), and Marres, O. and Weber, D. (2012), for example.

economies to collect revenue in a globalized world – forms the basis for the discussion.[320] Thus, much of the discussion focuses on the impact on corporate behavior (efficiency and neutrality) of different solutions for classifying debt and equity and/or how these solutions relate to state tax revenues.[321] Accordingly, the theoretical basis for this discussion is primarily financial theory and theories of public economy.[322] Knowing, however, that a fundamental basis for all tax systems is that the taxpayer – eventually the individuals within the taxing jurisdiction – perceives the tax system as fair, we consider equal taxation merely as a relevant basis for evaluating legal classification within a tax system.[323] Thus, this chapter takes a somewhat different perspective on a subject that has already been heavily debated. Its explicit purpose is to present tax equality (horizontal equity) as a reason for treating income from debt and equity differently, and to demonstrate how the general trend in corporate income taxation (treating debt and equity alike) challenges the eligible horizontal equity. We use the Swedish income tax system in our presentation, illustrating its development from equal income taxation to unequal but (deemed) effective corporate income taxation.

1.3. Outline

The remainder of this chapter is organized in three parts, the first of which – Section 2: *Taxing financial instruments* and Section 3: *Distinguishing between debt and derivatives* – presents the general structure of the Swedish tax system and the basics of financial engineering. The purpose of these sections is to present the conditions which have eventually motivated the Swedish tax law maker to abandon equal taxation. The second part of the chapter – Section 4: *Taxation of capital income* and Section 5: *The problem and how it is handled* – presents legal development within the relevant areas, why this development was found unsatisfactory, and how it was dealt with in new legislation. Section 6: *Unequal taxation* and Section 7: *Conclusions* illustrates the effects that the new regulations have had and will have on capital taxation, and the extent to which these effects are in accordance with the fundamental principle of equal taxation. Finally, this section summarizes the chapter and presents some concluding remarks.

2. Taxing financial instruments

2.1. General characteristics

Our key conclusion in this chapter is that derivatives cause insoluble classification issues that severely challenge the traditional tax system, in which the treatment of financial instruments is based on their

[320] See Bundgaard, J. (2014), and Eberhartinger, E. and Six M. (2009), for example. See Folkvord, B. and Riis Jacobsen, M. (2014) regarding the international challenge and its impact on the Nordic countries.
[321] See Bärsch, S-E. (2012) pp. 44–52, and Marres, O. and Weber, D. (2012), for example.
[322] See generally Blessing, P. H. (2012).
[323] See e.g. Avi-Yonah, R. (2006); and Alley, C. and Bentley, D. (2005).

legal form.[324] Knowing that derivatives and other financial instruments are often perceived as a relatively challenging area within tax law, the following sections present some general bases on the characteristics of derivatives and other financial instruments, and how they generate income.

2.2. Derivatives

Throughout this chapter, we are referring to plain vanilla derivatives, forwards and options, which are explained in greater detail in Section 3.2. At this point, however, it is worth noting that *derivatives are financial instruments that provide returns directly related to the returns of the instrument that underlies it* – corporate stock, for example. There is a difference between investing in a corporate stock and investing in its derivative: The derivative investment demands less capital, yet the possible return can be the same. Thus, in relation to an investment in corporate stock, an equity derivative provides a much higher return and is often referred to, therefore, as a *leveraged instrument*.

2.3. Three subcategories of financial instruments

A *financial instrument* can broadly be defined as

> *…any evidence of the legal relationship arising from the provision of money, property, or a promise to pay money or property by one person to another in consideration for a promise by the other person to provide money or property at some future time or times, or upon the occurrence or non-occurrence of some future event or events.*[325]

In Swedish income taxation, it has been found necessary to divide these instruments into at least three subcategories: *debt, equity,* and *derivatives on assets other than debt and equity*. In the corporate income taxation system, the distinction between debt and derivatives has been of limited importance because the returns from either kind are treated alike. Because the return from equity is treated differently, however, the distinction between debt and equity has been a major issue in corporate income taxation. Furthermore, because debt is treated favorable to equity and to derivatives on other assets when held by individuals, Swedish taxation of individual capital income includes classification issues between debt and equity and between debt and derivatives.

2.4. Return from financial instruments

2.4.1. Two kinds of income

In analyzing the income taxation of financial instruments, it is important to understand that these instruments provide two types of income – *income from production* and *windfall gains (speculation income)*. The holder of a financial instrument may, in many situations, choose whether the income shall

[324] See Section 7.
[325] Edgar, T. (2000) pp. 4–5.

be distributed as current income or as capital gains. Thus, the following sections briefly outline the general differences between these two types of income and how that income may be distributed.

2.4.2. Income from production

The extensive concept of income used in Swedish income taxation includes income from production and from windfall gains.[326] Income from production generally equals Sweden's net domestic product (NDP), which leads to the conclusion that NDP never exceeds the investor's total income. This conclusion is challenged, however, if those who invested in Swedish production have large debts to or claims in foreign countries. In cases in which investors have large debts to foreign countries, their net income will be reduced, and will therefore become smaller than their production output.[327] If an investor has large claims in foreign countries, the opposite occurs.

If capital is invested in production, the return from the investment will be distributed as interest, dividends, or capital gains. The legal contents of these concepts are further discussed in Section 4. In order to facilitate the understanding of these legal concepts, however, it is necessary to stress that a capital investor may, in many situations, be able to choose whether the value of the production shall be distributed as dividends and/or interest or as capital gains. If the owner of a company decides that no dividends shall be paid, the value of the owner's shares will increase correspondingly with the value of the forgone dividends and will be distributed as capital gains when the shares are disposed of. Equally, if the holder of a bond disposes of it before maturity, the bond holder's capital gain will correspond with the value of accrued interest. It is therefore necessary to treat current income and capital gains and losses from the same kind of financial instruments equally in the tax legislation in order to avoid *tax arbitrages: profiting from tax shelters or differences in the way income or capital gains are taxed*.[328]

2.4.3. Income from speculation – windfall gains

As mentioned in the previous section, Swedish income taxation does not merely cover income from production; it also taxes several kinds of windfall gains. The main difference between these two kinds of income is that income from production equals the value added in society, whereas a windfall gain is an income that does not correspond to any value added in the society. Thus, a windfall gain always corresponds to a windfall loss. A *forward contract – whereby one party agrees to buy and another agrees to sell an asset in the future to a price agreed upon today* – is a typical example of a capital investment that results in windfall gains and losses. Such a derivative contract has no initial value and eventually involves one of the contracting parties paying money to the other party without getting anything in

[326] The concept of income generally corresponds to what is commonly referred to as the Schanz-Haig-Simons concept of income; see for example Holmes, K. (2001) pp. 55–57.
[327] Within income taxation, this is generally referred to as *base erosion*.
[328] For example, the Swedish income exemption on dividends from substantial holdings applies also to capital gains and losses on those holdings; Ch. 24 and 25a ITA.

return. Thus, it is a zero-sum game, resulting in no value added to society. Just like gains from investments in production, however, windfall gains on financial instruments are classified as capital gains in Swedish income taxation.

2.5. Financial income

From what has been argued in Section 2.4, it is possible to conclude that *financial income – interest, dividends,* and *capital gains – is the sum of a tax subject's return from capital investments in production and windfall gains*. Because it is possible to speculate about the success of future production in a company, the return from equity derivatives and the actual equity instrument – the underlying corporate stock – is related. This means that it is possible to replicate the return from a company stock (production) by the use of derivatives (speculation).[329] Consequently, it is rational, in terms of income tax equality, to treat the return from derivatives equal to the return of underlying assets.[330]

We argue that financial instruments that typically produce windfall gains and losses (derivatives) can be merged with financial instruments that typically produce income from production (equity and debt). Because, in many situations, the investor in equity and debt can choose if the return from the investment shall be distributed as capital gains or interest/dividends (see Section 2.4.2), situations may occur in which the periodic return from debt (interest) is, in substance, a windfall gain. It is unawareness of this transformation of the return that really makes a mess of capital income taxation.[331]

2.6. A risk-based tax system aimed at horizontal equity among sources of personal income

In Section 4, we present the purpose of today's tax system. Before that analysis, however, we comment on the structure of the system in order to explain the perspective of the tax legislator, particularly how the legislator views the characteristics for certain capital investments: debt and equity.

A general purpose of the Swedish income tax reform of 1990 was to accomplish horizontal equity for produced income – among different types of capital income and income from labor.[332] This ambition indicates that the tax system is based on the assumption that personal income is the relevant perspective, making corporate income taxation an integrated part of personal income taxation rather than an autonomous tax system.

When the Swedish income tax system was launched in the early 1990s, the effective tax rate on income from labor was, for the majority of Swedish laborers, approximately 60%, including payroll tax. To achieve horizontal equity in the taxation of income from labor, and real capital income, Sweden uses a

[329] See Section 3.3.
[330] See, for example, Hilling, A (2007), pp. 82–83.
[331] See Section 5.
[332] See Section 4.1

classical system. Table 1 shows how the tax system was constructed to achieve horizontal equity between real income from debt and equity:

Table 1: Equal taxation of real income from debt and equity

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	4.00%	1.96%	61.20%

Note: In order to target the effective tax rate of wages at approximately 60%, dividends are subject to double taxation and interest is not. Relevant tax rates from 1990 are used in this table.

Source: Authors.

Table 1 illustrates that the design of the tax system is based on the assumption that debt is an investment that generally provides lower return than equity does. It also shows that interest is assumed to be a return that does not greatly exceed inflation. Under these circumstances – a risk-based tax system – the taxation of capital investments adheres to the goals of horizontal equity.[333] It is noteworthy that the structure of the tax system is based on the assumption that equal taxation cannot be fulfilled if debt and equity are not treated differently. Consequently, their altered characteristics in regard to financial risk must have been considered, by the legislator, too great to meet the general purpose of horizontal equity without treating debt and equity differently.

2.7. Summary

Taxable income can be divided into income from production and windfall gains (speculation income). Capital income from production is classified as dividends, interest, or capital gains. Capital income from windfall gains is classified as capital gains. This makes it possible to conclude that a capital gain may result from an investment in production or speculation, but that dividends and interest always represent income from production. In the next section, however, we argue that, in many situations, it can be difficult to define whether a capital investment is, in substance, an investment in production (debt) or an investment in speculation (derivative). An unsuccessful classification may lead to the return from an investment in production (debt), being treated in substance as a return from an investment in speculation (derivative), although the return is legally classified as interest when distributed to the investor. Because the structure of the tax system requires debt to be a financial instrument with low risk, classifying speculative activities as debt may severely challenge the functioning of the tax system.

[333] For a discussion about taxation with a risk-based classification of debt and equity see, for example, Ceryak, D. V. (1990) and Politio, A. P. (1998).

3. Distinguishing between debt and derivative

3.1. Financial Engineering

Financial engineering may be generally defined as the development and creative application of innovative financial technology.[334] The decade before the financial crisis in 2008 saw massive growth in financial engineering, heavily increasing the pace and complexity in the development of new financial products. Consequently, the financial landscape is fundamentally different today compared to the time when the current income tax system was designed and drafted. In this section, we illustrate how basic financial engineering challenges the concepts of debt and equity, as perceived in the income tax system. In particular, financial engineering challenges the conception that debt is always a financial instrument with low financial risk.

3.2. Arbitrage and replication

3.2.1. No arbitrage assumption

The basis for any financial engineering is a relatively straightforward exercise: *asset pricing. The price of any financial asset is the discounted future cash flows of that asset*, which implies that the discount rate and the required rate of return is the same. This is true for stocks, bonds, options, credit default swaps, and all other securities. It is difficult, however, to find the correct future cash flows and the correct discount rate. Asset pricing is primarily concerned with finding discount rates, whereas forecasting future cash flows for a company, for example, is the domain of analysts.

A standard assumption in asset pricing is the *principle of no arbitrage, where arbitrage is ".. a portfolio that guarantees net cash inflows without any net cash outflows"*.[335] From the no-arbitrage assumption, it follows that assets with identical cash flows must have identical prices. This idea is used extensively when pricing derivatives through *replication: finding assets or portfolios of assets with known prices that have exactly the same cash flows as an asset with an unknown price*. It follows from the no-arbitrage principle that the asset with an unknown price must have the same price as the portfolio that replicates its cash flows.

3.2.2. Bonds

For some instruments, such as bonds, the future cash flows are known at the time of purchase. When the cash flows are known and a market price is observed, the *discount factor, which is also called the expected or required return of the asset*, can be directly calculated without any model assumptions. Using a simple example, we take a zero-coupon bond with exactly one year to maturity with a nominal value of N. The price (P) is observable if the bond is traded on a market and theoretically given by

[334] Beder, T. (2011) p. 3.
[335] Sundaram and Das (2011), p. 60.

$$P = \frac{N}{1+y}$$

where *y* is the required rate of return on the bond. To get the discount rate, we use the fact that P and N are known, and solve for *y.* Thus, we get

$$y = \frac{N}{P} - 1$$

When the time to maturity differs from one year or when the bond has coupon payments, the mathematics are more complicated, but the principle is the same. So the required rate of return can be inferred for any traded bond.

3.2.3. Forward

To expand upon a previous definition, *a forward contract is an obligation for one party to buy and for another party to sell an asset (the spot asset) to a price agreed upon today, called the forward price*. The spot asset is delivered at an *agreed-upon future date called the maturity date*.

The forward price is set so that that the contract has a price of zero; no cash flows are exchanged between the buyer and the seller at the contract date. At the delivery date, the seller delivers the product and the buyer pays the forward price. This is how a forward contract can be replicated by the spot asset and a zero-coupon bond:[336]

Holding a forward contract will provide one unit of the underlying asset at the time of maturity. To replicate this holding, one can simply buy the spot asset instead and hold it until maturity. Because both these transactions provide the same asset, both must have the same cost. The cost of buying the spot asset using the forward contract is the forward price (F), which is paid at delivery, so the price today is the present value of the forward price, which we denote PV(F). The cost of buying the spot asset is the current spot price today, plus such other possible costs as storage and insurance, depending on the nature of the spot asset. (For simplicity's sake, we ignore these extra costs here.) By setting the costs equal, we must then have $PV(F) = S$ or expressed differently, $F = S(1 + r)$ with r being the discount rate. Following is an example of creating an arbitrage profit when the relationship described in this paragraph is not true.

[336] Sundaram and Das (2011) pp. 61–62.

Example: Assume that the spot price of gold is $300, the forward price is $311 for delivery of gold one year from now, and the rate of interest is 2%. The theoretical spot price should then be $300(1 + 0.02) = 306$. Because the market price of the forward contract is too high, we sell the forward contract and buy the spot asset today, which requires us to borrow $300 at an interest rate 2%. After one year, we deliver the spot asset and get our $311. Repaying our loan with interest will cost us 1.02 x $300 = $306, resulting in a riskless profit of $5.

Note that in order to replicate a short position in a forward contract, one must borrow money (sell a zero-coupon bond) and to replicate a long position in a forward contract, one must deposit money (buy a zero-coupon bond), which means that any forward contract can be seen as a combination of the spot asset and a zero-coupon bond.

3.2.4. Options

A *European call option gives the buyer of the contract the option to buy the spot asset (the underlying asset) at a pre-specified price, called the strike or exercise price (X), at a pre-specified future date (T), called the maturity date.* The seller of the call option contract has a binding obligation to sell the spot asset if the buyer chooses to use the option. *An American call option can be used at any time at or before the maturity date.* (The terms "European" and "American" do not refer to the location where the contracts are geographically traded.) *A put option gives the buyer the right to sell the spot asset, and consequently the seller of the put option has the obligation to buy the spot asset.*

An option can be replicated by owning (or selling short) a fraction of the underlying asset, while simultaneously having a short or long position in a bond (borrowing or lending money). To replicate one call option, for example, one must own less than one unit of the spot asset and borrow some money. The call option is therefore equivalent to a leveraged position in the spot asset. The exact quantities – the fractional quantity of the spot asset owned – can be calculated if one is willing to assume a particular option-pricing model; the quantities will depend on the relationship between the spot price and the strike price and on the volatility of the spot asset.

We now introduce the option-pricing model that is still, after 40 years, the one most widely used: the Black and Scholes option pricing model,[337] which gives the price of a call option as

$$C = S \cdot N(d_1) - X \cdot N(d_2)e^{-r(T-t)}$$

where $d_1 = \frac{\ln\left(\frac{S}{X}\right)+(r+0.5\sigma^2)(T-t)}{\sigma\sqrt{T-t}}$ and $d_2 = d_1 - \sigma\sqrt{T-t}$. S is the price of the spot asset, N is the cumulative distribution function of the standard normal distribution, X is the exercise or strike price, e is the

[337] The model was developed in Black and Scholes (1973) and Merton (1971).

mathematical constant $e \approx 2.72$, r is the risk-free rate of return, T-t is the time to maturity of the option, and σ^2 is the return variance of the spot asset. All quantities are expressed on a yearly basis. The interpretation of $N(d_1)$ and $N(d_2)$ is, loosely speaking, the probability that the option will be exercised at maturity.

The mathematics may look uninviting, but the intuition behind the formula is straightforward. The formula simply states that the price of the call option is equal to what one would expect to get (the spot asset with probability $N(d_1)$) minus the present value of what one would expect to pay ($X \cdot N(d_2)$).

Because the moneyness of an option measures the probability that the option will be exercised, moneyness increases for a call option when S/X increases. Because X is fixed for a given option contract, moneyness increases when S increases – when the spot asset increases in value. An option with high moneyness (S>X for call and S<X for a put) is said to be in the money, when S is much larger than X (smaller for a put) the option is said to be deep in the money. A deep-in-the-money option behaves more and more like a spot asset; when the spot price tends to infinity, a call option behaves like the spot asset. We show this formally by calculating the call option price, C, in the limit when S tends to infinity:

$$\lim_{S\to\infty} S \cdot N\left(\frac{\ln\left(\frac{S}{X}\right) + (r + 0.5\sigma^2)(T-t)}{\sigma\sqrt{T-t}}\right) - X \cdot N\left(d_1 - \sigma\sqrt{T-t}\right)e^{-r(T-t)}$$

$$= S \cdot N(\ln(\infty)) - X \cdot N(\infty)e^{-r(T-t)} = S - Xe^{-r(T-t)} \approx S$$

The second equality follows from using $\lim_{x\to\infty} N(x) = 1$, and the approximate equality follows – simply because S is much larger than X.

3.3. Hybrid instruments

3.3.1. Legal classification

To this point we have illustrated that the return from derivatives – forwards and options – can be fully replicated by means of a bond and (a fraction of) the underlying of the derivative. From an income tax point of view, this means that it is possible to replicate a derivative on a company stock by means of financial instruments with the legal classification of debt (a bond) and equity (stock). Thus, when it comes to returns – income – an equity derivative is a hybrid between debt and equity. Because the tax treatment of debt and equity differ, the hybrid character presents a potential classification problem. To solve this problem, it seems necessary to find a way to distinguish between the debt part and the derivative part of the hybrid contracts. *To tear a financial instrument into its component parts and treat them as building blocks is generally referred to as bifurcation*. Bifurcation is not an option, however,

because like most other tax systems, the Swedish income tax system treats financial instruments as indivisible contracts when classified as debt or equity.[338] Thus, the *hybrid instrument must be classified as either an equity derivative or a debt – a classification generally referred to as the all-or-nothing approach.*[339]

The classification of a financial instrument as debt or derivative will be relatively challenging in many situations, however, because the character of the derivative is continuously shifting in proportion to the instruments it replicates: a bond and the underlying. Thus to classify a financial instrument as debt or a derivative of a certain underlying may be an impractical exercise, as illustrated in the next sections.

3.3.2. The shifting character of an option

In Section 3.2.4, we illustrate that the return from an option can be replicated by a bond and a fraction of the underlying. An option in equity is thus a replica of what is legally classified as debt and equity. To calculate the debt fraction of an option, we can again use the Black and Scholes model, which shows that a call option is replicated by $C = S\Delta_c - B_c$ where $\Delta_c = \mathrm{N}(\mathrm{d}_1)$ and $B_c = \mathrm{X} \cdot \mathrm{N}(\mathrm{d}_2)\mathrm{e}^{-\mathrm{r}(\mathrm{T}-\mathrm{t})}$.

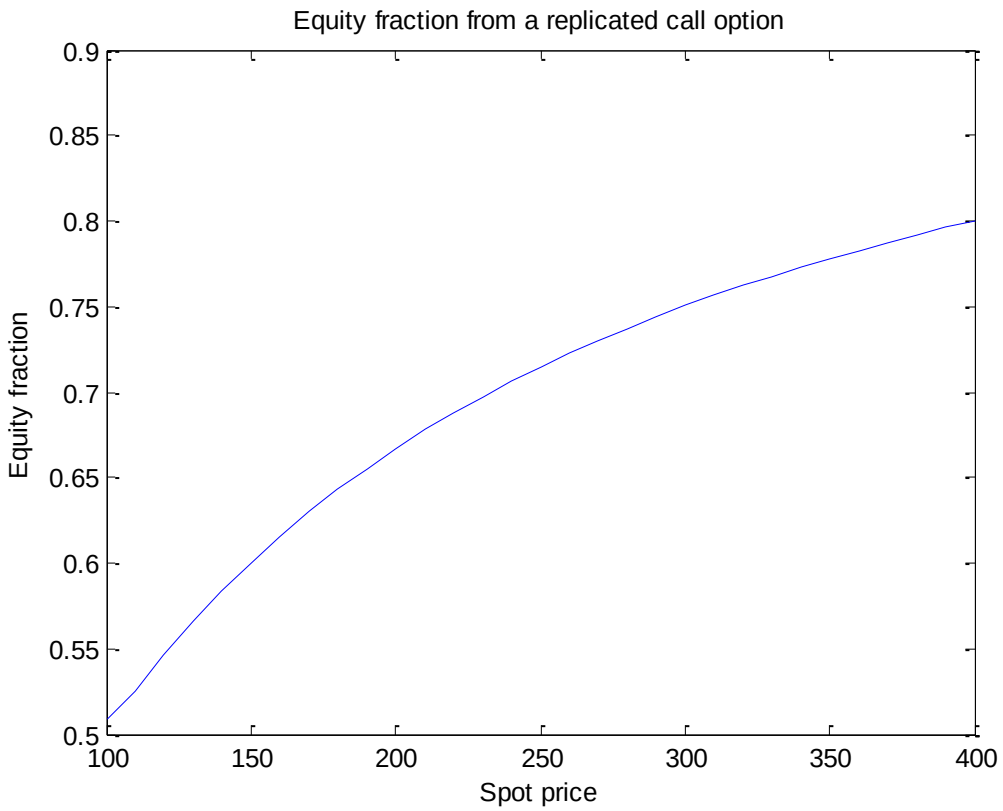
The interpretation is that B_c , the amount of money one must borrow and $S\Delta_c$ that provides the fraction of the spot asset to buy (Δ_c is never larger than one). If we assume that the underlying asset is a stock, we can then see that an option is a combination of debt and equity, and the proportion that is equity depends on the moneyness of the option through $\mathrm{N}(\mathrm{d}_1)$ and $\mathrm{N}(\mathrm{d}_2)$.. As calculated above, for a very deep in-the-money call option, we get $\mathrm{N}(\mathrm{d}_1) = \mathrm{N}(\mathrm{d}_2)$=1. So we get

$$C = S - \mathrm{X}\mathrm{e}^{-\mathrm{r}(\mathrm{T}-\mathrm{t})}$$

The option is equal to the stock value plus borrowing the present value of the strike price, so in this case the option is almost pure equity. We define the commodity fraction to be $S\Delta_c/C$ and calculate the equity fraction for a hypothetical call option with a volatility of 15%, a time to maturity of 1 month, a risk-free rate of interest of 2%, an exercise price of $100, and a spot price ranging from $100 to $400.[340] The equity fraction ranges from 50.8% to 80.0%, and by using ever-higher spot prices, the fraction would eventually approach 100%. Note that this result not only reveals that different option contracts can have very different equity/debt proportions, but that the same option contract can have vastly different equity/debt proportions over time, due to changes in the price of the underlying asset.

Figure 1. Equity fraction form a replicated call option

[338] RÅ 1994 ref. 26.
[339][339] See generally Madison Jr. R. B. (1986).
[340] The results are not sensitive to the choice of volatility, risk-free rate, and time to maturity.



Note: This figure shows the equity fraction from a call option replicated by the spot asset and a bond.

Source: authors.

3.3.3. Prepaid forwards

A prepaid forward contract is identical to a forward contract, with the single difference that the forward price is paid when the agreement is entered upon and not when the spot asset is delivered.[341] This difference creates slight changes to the replication strategy. The cost of buying the spot asset using the forward contract is still the forward price (F), which is paid at today's price, so the price today changes from PV(F) to simply F. If we once again ignore costs of storage, insurance, and possible dividends, the prepaid forward price is simply equal to the spot price F = S, because the cost of buying the spot asset on the spot market and using the prepaid forward contract is the same. If we add storage costs (m) expressed as a fraction of the spot price, we get F = S(1+m), and there is now a difference between the prepaid forward price and the spot price: When we use the prepaid forward contract rather than buying the asset on the spot market, we avoid paying storage costs.

We now know that a prepaid forward price is identical to the price of the underlying asset: F = S. We also know, however, that it is possible to replicate the underlying (asset) by a portfolio with a regular

[341] See Section 3.2.3.

forward contract and a bond.[342] Consequently, a prepaid forward contract is, in substance, a portfolio with a regular forward contract and a bond. Because financial instruments are generally treated as indivisible contracts, a possible solution is to classify these contracts as derivatives, thereby dealing with tax arbitrage possibilities.[343]

The other possible way of dealing with prepaid forward contracts for income tax purposes is to classify them as debt instruments, because of the initially large debt fraction in the contract. This line of reasoning opens up possibilities for creating extremely risky debt instruments. If a prepaid forward contract with equity as an underlying is classified as debt, for example, the debt instrument will have the same financial risk as the underlying asset. Consequently, prepaid forward contracts may facilitate the taxpayer's ability to invest in a certain asset by a direct purchase of the asset, or through the use of a debt instrument. When the underlying is corporate assets (equity), it may be advantageous for the taxpayer to make the investment by a prepaid forward contract – a debt.[344]

3.4. Ever-changing characteristics

We have now illustrated how options and forwards work, and how they can be used to replicate a portfolio with a bond and the underlying of the derivative. As the moneyness of the derivative increases, the equity fraction of the derivative also increases, at the expense of the size of the derivative's debt fraction. For the issuer of such derivative the opposite occur. Consequently, the issuance of deep-in-the-money options, and prepaid forward contracts, have many characteristics similar to the issuance of regular debt instruments. Unlike regular debt instruments, however, the debt characteristics of a derivative may decrease or even disappear over the duration of the instrument. Because of the ever-changing characteristics of derivatives in relation to the legal definitions of the instrument in its replica portfolio, the classification of financial instruments as debt or derivatives will always be uncertain.

Fixing the time at which a financial instrument shall be legally classified as debt or a derivative is a standard way of dealing with uncertainty caused by the shifting character of hybrid financial instruments.[345] Swedish case law has determined the relevant time to be the point at which the instrument is issued.[346] In principle, this fixed-time approach increases legal certainty, which is good, of course; but it does not deal with the actual problem caused by hybrid financial instruments: high-risk debt instruments. In fact, it can be argued that using the time at which it is issued as the basis for

[342] See Section 3.2.3.
[343] Such treatment can be criticized because the relatively large debt fraction of the contract is treated differently from regular debt, see e.g. Edgar, T. (2000) 246–sequent.
[344] See Section 4.3.
[345] See Polito A. P. (1998) pp. 803–805.
[346] RÅ 2008 ref. 3.

classifying a financial instrument creates the possibility that high-risk derivatives can be classified as debt instruments as long as they are issued deep in the money.

Bifurcation has been described in the literature as the most effective way of dealing with income-tax problems of high-risk debt instruments – hybrids.[347] As mentioned previously, however, bifurcation – treating the financial building blocks of a financial instrument separately for tax purposes – is not an option in Swedish income taxation because the Supreme Administrative Court (SAC) has identified its opposite, the "all-or-nothing" approach, as the prevailing rule.[348]

3.5. Summary

In this section, we have explained that derivatives with large moneyness are similar to regular debt instruments. It may be challenging, therefore, to find ways to distinguish legally between debt and certain derivative contracts – hybrid instruments. As a result, when hybrid instruments (derivatives with large moneyness) are legally classified as debt instruments, the perception of debt as low-risk financial instruments is severely challenged. Tax systems, Sweden's included, which have preferential treatment for debt income, expose themselves to serious tax-arbitrage schemes, such as tax planning with inter-company interest deductions.

In the next section we illustrate how this "insoluble" classification issue has challenged the Swedish income tax system, and the traditional classifications of financial instruments as debt and equity was eventually abandoned.

4. Taxation of capital income

4.1. Purpose of the law

4.1.1. Preparatory works

In this section, we briefly present the purpose of the relevant tax law, based on what is set out in relevant legal preparatory works. The Swedish tradition of extensive preparation of legislation involves several types of preparatory works.[349] For interpretation of tax law, the key types are Government bills (*propositioner, Prop.*) and Ministry of Finance Committee Reports (*Statens offentliga utredningar, SOU*), to which we refer in this section.

4.1.2. Equal taxation

With direct reference to the ability-to-pay principle and the constitutional principle of equality, an explicit purpose of the Swedish tax reform of 1990 was to attain equal taxation: "…that persons with

[347] See e.g. Madison Jr. R. B. (1986), Politio, A. P. (1998), Edgar, T. (2000), Hilling, A. (2007).
[348] See Section 3.3.1.
[349] For a discussion of the different kinds of preparatory works, see, for example, Melz, P. (2007) p. 137.

equal income, wealth etcetera are taxed alike…"[350] In the context of a dual-income tax system, which was introduced in Sweden by this tax reform, it was decided that any return from any type of asset was to be taxed equally in the income tax schedule Capital income.[351] This is generally referred to as a flat-rate tax on capital income, but must not be mistaken for the flat tax on savings and investments, which is described in Section 5.2.1.[352] Theoretically the flat tax on capital income involves a relatively complex taxation of income on an accrual basis.[353] For reasons of simplicity and taxpayers' ability to pay, however, accrual taxation was dismissed in favor of the cash basis and the *realization principle (revenue can be recognized only after the goods or services have been delivered)*.[354] As a result, current investment income, such as interest and dividends, is taxed in the same period that the taxpayer has access to the return. Other returns – capital gains and losses – are taxed when the asset is disposed of.

In summary, the equality and distinctiveness of the legislation is satisfied when all returns on capital – current income as well as capital gains and losses – are taxed in the same income tax schedule and in the same way, independent of the type of income-generating asset. Equality does give way to distinctiveness, however, when accrual income recognition is dismissed in favor of cash basis and realization. The only inequality this deviation may create is that the real income classified as capital gains will be reduced over time due to inflation, and may therefore be taxed somewhat higher than interest and dividends because of the nominal calculation of taxable income. In relation to investments in financial assets, this is really not a big issue, particularly because inflation has been relatively moderate since the launch of the relevant tax legislation.

4.1.3. Limitation of potential, unwanted tax credits

Although the use of a different principle for the periodization of income does not severely challenge equal taxation of the positive return from financial investments, use of the realization principle causes some difficulties. This situation exists because the realization principle facilitates the creation of tax credits, which would have been impossible through consistently applied accrual income recognition.[355] A tax credit is, in effect, an interest-free loan from the government to the taxpayer, and it typically occurs when a taxpayer knowingly brings forward the realization of a loss position and pushes the realization of gain positions into the future.[356] Because the possibility of generating tax credits is clearly in conflict with a goal of equal taxation, measures have been taken to limit the taxpayer's ability to enhance such

[350] SOU 1989:33 part I, p. 52, see also Prop. 1989/90.:110, part I, p. 388. This and all other translations from Swedish to English have been done by the authors
[351] SOU 1989:33 part I, p. 63–64, SOU 1989:33 part II, p. 14.
[352] See e.g. Birch Sorensen, P. (1994).
[353] SOU 1989:33 part I, pp. 56–57. About accrual taxation, see Shakow, D. (1986).
[354] SOU 1989:33 part II, pp. 32–37, Prop. 1989/90:110, part I, p. 396–399.
[355] Shakow, D. (1986) p. 1117.
[356] SOU 1989:33 part II, p. 41. See also Hilling, A. (2007) pp. 56–57.

credits. These measures took the form of general deduction limitations of 70% of capital losses. Deduction limitations for capital losses are significant exceptions to the goal of equal treatment of current returns and capital gains and losses within the income tax schedule, Capital Income. This is so because interest expenses are usually fully deductible against any kind of capital income, as further explained in next section.

4.1.4. Interest expenses favored to capital losses

Deductibility for interest expenses is not limited the same way that capital losses are, a situation motivated primarily by housing policy. It was decided that interest expenses on private homes should be fully deductible against wages. Because the dual income tax system treats capital income and income from labor separately, however, the technical solution is a tax credit of 30% of the deficit in the income schedule capital, which is fully deductible against wages, with an effective tax rate of 30%.[357] The difference in the deductibility of capital losses and interest expenses were not entirely consistent, however.

Capital losses on interest-paying financial instruments are treated as interest; there is no restriction or quota on interest cost deductions for those instruments as there are for other types of capital losses. This inconsistency exists partly to avoid demarcation problems in classifying returns as interest or as capital gains or losses. Furthermore, it was considered that a deduction limitation for these capital losses would be unduly restrictive, because potential tax credits would still be relatively small with respect to the limited durations and moderate rate variations of these instruments.[358] For control reasons, only publicly traded instruments were exempted from quota. Here again, it becomes evident that the tax-law maker considers debt a financial instrument with low risk.[359]

4.1.5. Effective taxation of corporate investments

Finally, the tax reform of 1990 highlights the need for effective tax legislation regarding investment in corporations. A general purpose of the legislation was therefore to ensure that it would never be more advantageous to invest in a corporation by means other than a regular corporate share. Thus, any investment for which the return is connected in one way or another to the return of a corporation is to be treated for tax purposes as equal to corporate shares.[360]

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[357] See Prop. 1989/90:110, part I, pp. 402–404, Prop. 1990/91:54, pp. 215–216, Prop. 1991/92:60, pp. 77–80.
[358] SOU 1989:33 part I p. 128, part II p. 162, Prop. 1989/90:110, part I, pp. 402–404.
[359] See section 2.6 above.
[360] Prop. 1989/90:110, pp. 430–434. This is also stated in the relevant legislation: Ch. 48 § 2 IL.

4.1.6. Classifying capital investments

From what is stated in the preparatory works of the relevant tax legislation, it is obvious that return-from-capital investments shall generally be taxed equally. There are three additional and superior purposes, however, in the taxation of capital investments:

- Limitation of potential tax credits
- Elimination of classification issues between interest and capital gains and losses
- Effective taxation of corporate investments

In principle, the three additional purposes do not threaten the general purpose of equal taxation. If *all* capital investments were subject to limited deductibility of capital losses, the equal taxation would remain. Because interest is fully deductible from capital income, however, the purpose of eliminating classification issues between interest and capital gains and losses involves the treatment of these gains and losses as equal to interest if the relevant instrument is an interest-paying one.[361] It seems necessary, therefore, to classify capital investments in at least two different categories, one of which is not subject to limited deductibility for capital losses. It can be argued, however, that it is impossible to isolate interest-paying instruments from other financial instruments, because all financial instruments can have returns in the form of interest – if they are purchased at a discount, for example. Consequently, it seems unmanageable to find a classification norm that isolates interest-paying instruments from other financial instruments. Instead, in order to separate financial instruments with low risk or debt, the classification must focus on financial instruments with potential returns similar to a regular interest rate.

If it were possible to find a legal classification that captures all financial instruments with potential returns similar to regular interest, everything would be fine. Such a classification would fulfill the purpose of eliminating classification issues between interest and capital gains and losses, and would also correspond with the purpose of limiting potential tax credits, because the moderate return from these instruments make them insufficient for such tax planning. The only weakness in this classification would be the potential challenge to an effective taxation of corporate investments; if it includes financial instruments with returns related or similar to a corporate share. Consequently, there must be a tradeoff between the purpose of eliminating classification issues and the purpose of effective taxation of corporate investments. A discussion of whether or not this suggested classification is mirrored in the relevant tax law is presented in the next section.

[361] See Section 2.4.

4.2. The law

4.2.1. Interpreting the law

The income tax law relevant to the taxation of capital investments originates in the tax reform of 1990. A general tendency in the statutory style of that time was to avoid enumerations in the law, and instead to formulate more abstract rules giving the courts the opportunity of dealing with new types of transactions and placing them in proper legal categories.[362] Regarding capital investments, financial instruments are divided into four categories, one of which involves the exceptional treatment of full deductibility of capital losses: debt.[363] Of the additional three categories, one captures financial instruments, with returns related to or similar to corporate shares: equity.[364] In what follows, only debt and equity will be examined.[365]

During the decade after the tax reform, several precedent-setting court decisions regarding the classification of untraditional financial instruments were decided upon.[366] As a basis for these decisions, the law was interpreted in the light of the preparatory works to the legislation, which is in line with general tax law interpretation in Sweden.[367] As illustrated in the previous section, preparatory works set out the general principles for the tax system, and thereby facilitate the interpretation of the law. It is noteworthy, however, that preparatory works can never justify an interpretation of a statute contrary to its literal meaning.[368] Thus, the challenge for the law-making authority is to find a wording of the law that facilitates, in every possible case, the law being applied in concordance with the principles set out in its preparatory work (see Section 4.1.6). In the following section, we analyze the definition of debt and equity in relation to relevant court decisions. Our goal is to consult all relevant precedence court decisions since the relevant legislation was presented in 1990.

4.2.2. The legal concepts of debt and equity

The legal term "equity" explicitly includes corporate shares and any other financial instrument giving its holder a residual interest in the assets of a company after deducting all its liabilities, such as warrants. In addition, contracts with returns that are related to the return from equity instruments are to be treated as equity for income tax purposes; options serve as one example. Consequently, *equity can be said to cover any capital investment that gives the investor the right to share in the result of the production.*

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362 See Melz, P. (2007), p. 138.
363 *Fordringsrätt*, Section 48, section 3 ITA.
364 *Delägarrätt*, Section 48, section 2 ITA.
365 For information on the two additional categories – foreign debt and other income – see Hilling, A. (2008) pp. 702–707.
366 See footnotes 68, 70 & 71.
367 Melz, P. (2007) p. 138.
368 See e.g. Bergström, S. (2003) pp. 2–13 and Melz, P. (2007) p. 138.

To fulfill the purpose of effective taxation of corporate investments and to hinder potential tax arbitrages, speculative instruments in a corporation's production shall be treated as equity.[369]

The legal term *"debt" is defined as a claim of a certain amount of currency – a bond for example*. In addition, contracts with returns related to a debt instrument – a forward interest-rate agreement, for example – are to be treated as debt. Finally, it is explicitly stated that a financial instrument covered by the equity definition cannot be classified as debt. Thus, the tradeoff between the purpose to eliminate classification issues regarding interest and capital gains and losses, on the one hand, and the purpose of effective taxation of corporate shares, on the other hand, is to the advantage of effective corporate share taxation.[370]

Analyzing relevant case law on the classification of untraditional financial instruments, it appears that any financial instrument that gives a legal right to the invested capital is classified as a debt instrument, unless the instrument is related to equity in one way or another. Thus case law dealing with contingent debt instrument on equity and structured equity instruments classified as equity, are in line with expectations.[371] In the first of the referred cases, RÅ 1994 ref. 26, the Supreme Administrative Court (SAC) established a significant principle: that a contractually indivisible financial instrument is to be treated as a single, unique instrument for income tax purposes. Thus, the composition of a structured product is of no importance for income tax purposes.[372]

After the 1990 tax reform, the first untraditional financial instrument that SAC classified as a debt instrument was a real zero-coupon bond.[373] The fact that the potential return from this instrument is low and steady rather than volatile, and that its return is not related to equity, led to the conclusion that a classification of debt is perfectly in line with the purpose of the legislation. The same conclusion cannot be reached, however, in relation to the subsequent decision on the classification of a contingent debt instrument on foreign currencies.[374] In this decision, the SAC argued that because the instrument represents a claim in Swedish currency, it is a debt instrument; and because its return is not related to equity, it shall remain classified as debt.

[369] See Section 2.4.2.
[370] See Section 4.1.6.
[371] RÅ 1994 ref. 26 (contingent debt), RÅ 2000 not. 8 ("equity basket") RÅ 2001 ref. 21 (reverse convertible bond), RÅ 2001 not. 160 (swap), RÅ 2002 not 51 ("equity basket"), RÅ 2003 ref. 48 (contingent debt), RÅ 2007 ref. 3 (swap).
[372] See Section 3.4.
[373] RÅ 1995 ref. 71.
[374] RÅ 1999 ref. 69.

In this case, a literal interpretation of the law provided two possible classifications for the financial instrument. Besides its classification as debt, it would have been possible to classify it as a *forward contract (termin)*, which is defined as:

> *…a contract, suited for public trading, concerning*
>
> - *the purchase of shares, bonds, or other assets at a certain future date at a fixed price or*
> - *a future settlement, the amount of which is decided upon the basis of the value of the underlying asset, an exchange index, or similar.*[375]

It would definitely have been possible to classify the contingent debt instrument on foreign currency as a forward contract, based on a literal interpretation of the second section of the definition. This classification would involve an income tax treatment equal to the instrument's underlying asset: foreign currency. Given the purpose and the structure of the law, it would probably have been better to exclude these instruments from the debt concept, and classify them instead as derivatives. The same criticism can be leveled at the SAC's decision on a contingent debt instrument, the return of which was decided on the basis of which of three indexes had the most favorable development over the duration of the instrument.[376] Although the potential return of the contingent debt instrument was relatively volatile, it was classified as debt because its relationship to equity was not strong enough. The case law analyzed indicates that the legal concept of debt generally includes all types of financial instruments that are not classified as equity and that are not derivatives with low moneyness.[377]

It can be argued, of course, that the classification of contingent-debt instruments as debt does not threaten the purposes of the tax system; because these debt instruments guarantee nominal value, they will not give rise to any capital losses. Thus, tax credits or classification issues in relation to interest will never be an issue with these instruments. It is crucial, however, to remember that financial instruments are indivisible contracts in Swedish tax law. By allowing financial instruments with risk (other than the interest-rate risk) to be classified as debt instruments raises the possibility of speculative instruments – hybrid instruments – to be classified as debt instruments. Therefore, the legal challenges are not only to isolate debt from equity, but also to include any attempt to isolate debt from several types of derivatives:

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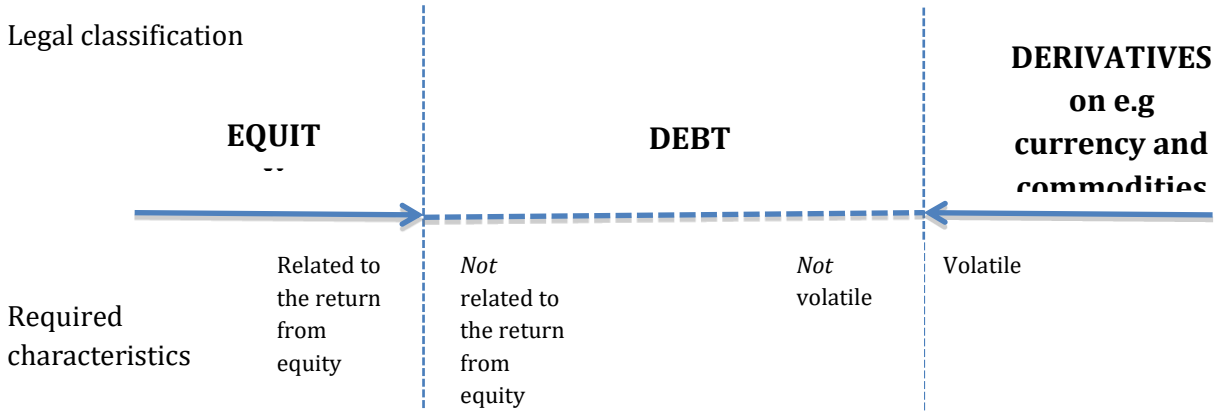
[375] Ch. 44, section 11 ITA.
[376] RÅ 2008 ref. 3.
[377] See Section 3.3.

Figure 2. Legal challenges in the classification of financial instruments as debt



Note: This figure shows required characteristics of financial instruments based on the purposes and structure of the law and classified as equity, debt, and derivatives on currency and commodities.

Source: Authors.

4.2.3. The debt–equity conundrum – financial risk

From the presentation of the legal concept of debt and equity and the presented court decisions, it is possible to conclude that equity and debt are broadly defined and that they sometimes comprise the same instruments – convertible bonds, for example. In such cases, the classification is based on the risk of the instrument rather than its legal form. Because the relevant financial risk is well defined – the risk of a corporate stock – the classification of equity is seemingly certain and efficient. It is noteworthy, however, that in many situations, a financial instrument classified as equity carries risks other than those of a corporate share. This is evident in the case of contingent debt instruments and exchange traded notes (ETNs), for example, which affected several equity investors when Lehman Brothers defaulted in 2008. Consequently, the legal concept of equity can be summarized as covering financial instruments of any kind, the potential return of which depends to a great extent on the risk of corporate stock.

4.2.4. The debt–derivative conundrum – legal form

Unlike the debt versus equity distinction, whereby the financial risk is found to be the decisive criterion for classification, the debt versus derivative distinction does not relate to financial risk. Here, the decisive criterion is legal form. Thus structured financial instruments, carrying the risks of currency or commodities, have been classified as debt according to Swedish income tax legislation.[378] The decisive

[378] RÅ 1999 ref. 69 and RÅ 2008 ref. 3, see Section 4.2.2.

criterion for a financial instrument to be classified as debt is that it should provide a claim for the investor to get the invested money in return at some future date.[379] The definition of debt does not include any requirement that the investment be risky; however, a literal interpretation of the concept of debt, as used in Swedish income taxation, does not exclude risky financial investments in commodities or currency or financial investments in bad debt – debt with large credit risks. This type of financial investment is classified as debt, therefore, unless there is another legal classification that suits the situation better. In the context of financial instruments, the only other legal classification is "derivative."[380]

Based on a traditional perception of the concepts of debt and derivative, where debt represents a bank deposit and a derivative is a plain vanilla forward contract with no initial value, it may seem surprising that it is sometimes difficult to separate the two types of instruments. Because the legal concepts of these instruments do not require any premises regarding financial risk or the amount of initial deposit in relation to possible return, however, the classification issue becomes a reality. There are, for example, uncertainties about the risk associated with a financial instrument before it disqualifies from the legal concept of debt, and how large an initial investment it is possible to transact in a financial instrument before it ceases to be classified as a derivative. These imprecise definitions make it possible to construct derivative-like financial instruments classified as debt. The potential high return from these instruments challenges the purpose of the legislation. The hybrids of debt and derivatives (high-risk debt instruments) constitute a key problem in classifying financial instruments. This issue is presented in Section 5 as the cause of extinguishing concepts of debt and equity from the Swedish income tax system.

4.2.5. Summary

An overall purpose of the Swedish income tax system is horizontal equity among different kinds of capital income – interest and dividends, for example. In the quest to achieve equal taxation, the structure of the tax system is based on the view that debt instruments are low-risk investments. For various reasons, presented in previous sections of this chapter, debt instruments must be separated from equity instruments and from financial instruments with other risks – commodity and currency for example. The methods for making these distinctions when applying the law have developed differently. The distinction between debt and equity is based on financial risk. Any financial instrument with financial risk linked to equity is taxed as equity. To a great extent, this classification norm excludes risky equity

[379] See Section 4.2.2.
[380] Forward (*termin*) or Option, Ch. 44 sections 11 and 12 ITA. See Section 3.2.2.

instruments from the definition of legal debt. Thus, within capital income taxation, hybrid equity instruments are seldom classified as debt when the classification is based on financial risk.

The method of distinguishing between debt and hybrid instruments with the financial risk of commodities and currency, for example, is based on legal form. Given the broad legal definition of debt, it includes hybrid instruments – derivatives with large moneyness. Including these financial instruments in the definition of debt creates the possibility for arbitrage, because debt instruments are no longer necessarily low-risk investments – the assumption upon which the tax legislator designed the system.

To conclude, in a situation in which debt is treated more favorably than other financial instruments, it appears that the debt must be distinguished from these other financial instruments based on the financial risk of the instruments rather than on their legal form. Unfortunately, this is not how it works in Swedish corporate income taxation, which is presented in next section.

4.3. Corporate income taxation

4.3.1. Distinguishing between debt and equity derivatives

So far we have presented the Swedish income taxation of individuals earning income from capital investment. In this context, we have recognized that the conventional tax system makes a distinction between debt and equity. Because the equity definition is based on financial risk, it is possible to classify untraditional financial instruments as debt or equity with some certainty. There are great uncertainties, however, in the classification of untraditional financial instruments as debt or derivatives because of the ever-changing characteristics of derivatives[381] and because the comprehensive definition of debt is based on legal form.[382]

The classification issues related to individuals are also relevant to corporations that make capital investments on the secondary market – as part of their cash management, for example. But unlike individuals, corporations may be subject to investments by issuing shares in their corporate assets. As is commonly known, these shares can be classified only as debt or equity.

The legal concepts of debt and equity in Swedish corporate income taxation are not identical to those used in the capital taxation of individuals, however. A key difference is that the concepts are based solely on legal form. Thus the difficulties in distinguishing between debt and derivatives in currency and commodities, as presented in relation to the taxation of individuals, are relevant also in relation to equity derivatives in corporate income taxation. Thus, equity derivatives may be classified as debt when issued

[381] See Section 3.4.
[382] See Section 4.2.2.

by a corporation on the primary market. A regular convertible debt instrument, for example, is, in substance, a contingent debt instrument in equity; it is classified as debt rather than equity by the issuing company. More untraditional equity-linked instruments, such as Preferred Equity Certificates (PEC) and Convertible Preferred Equity Certificates (CPEC), are also considered debt according to Swedish corporate income taxation.[383] In a recent decision from the SAC, however, a mandatory convertible debt instrument was considered equity.[384] By that decision, the SAC changed the appealed advanced ruling from the Swedish Tax Board, which considered the instrument as debt.[385] Although the Board relied on private law (Swedish company law) in its classification of the instrument, the SAC based its decision on relevant classification rules in international accounting standards (IAS 32).[386] The discord between the Board and the SAC in this case illustrates the uncertainty inherent in the classification of financial instruments as debt or equity.

The importance of the classification of financial instruments as debt or equity comes down to the fact that expenses related to equity (dividends) cannot be deducted, whereas expenses in relation to debt (interest) are deductible for the issuing company. The preferred tax treatment of expenses related to debt instruments creates inducements for issuing debt instruments rather than equity.

As illustrated in Section 3.2, the return from an asset can be replicated by a bond and a derivative. Furthermore, there are few, if any, differences between a portfolio with a bond and a derivative, on the one hand, and a derivative that is a deep-in-the money option, or a prepaid forward, on the other hand.[387] Thus in order to raise capital, a company may as well issue an equity derivative with large moneyness rather than issue traditional corporate stock. In a case in which such a derivative is classified as debt, its issuance is more favorable compared to the issuance of regular corporate stocks, although the value of the options are more or less equal.

To conclude, the hybrid financial instruments with characteristics of debt and equity are, in substance, derivatives with large moneyness. In Section 3.4, we have argued that these kinds of derivatives are almost impossible to classify as debt or derivative (equity) in a predictable way. The legal uncertainty will remain as long as the legal definitions do.

4.3.2. Converting capital losses into interest expenses

It can be argued, of course, that a hybrid debt instrument cannot be a derivative, because derivatives, unlike hybrid debt instruments, pay no interest – merely capital gains or losses. The issuer of the

[383] See e.g. Swedish Tax Agency (2012) pp. 88–93.
[384] Mål nr. 4745-13.
[385] Advance ruling decided 2013-06-19 (dnr. 4-12/D).
[386] See e.g. Olsson, S. (2014) and Bjuvberg (2014) for comments on this court decision.
[387] See section 3.3.

derivative may recurrently pay accrued capital losses on the derivative, however, and in that way make it appear as interest expenses.[388] Because these "interest expenses" are, in substance, capital losses on derivatives, the rate of that "interest" is equal to the required rate of return of the underlying asset: the issuing company's equity. Thus the rate of return on hybrid debt instruments are generally far above what can be expected from regular debt instruments. Accordingly, Swedish case law offers several examples wherein it has been considered in line with the law to deduct "interest" at levels equal to or above what can be expected as a return on regular equity investments.[389]

4.3.3. Related-party debt strategies

The opportunity to issue derivatives that are legally classified as debt and to convert accrued capital losses into recurrently payable interest expenses constitutes a tool for international tax planning. When a productive company issues these derivatives (hybrid debt instruments) to a related party, such as a parent company, the deduction of the "interest expenses" may be used to shift income between the residence countries of the related parties. If the income is produced in a high-tax regime, and the parent company is resident in a low-tax regime, the total tax for the company group will decrease. These related-party debt strategies for profit shifting have been recognized as a severe problem in international taxation and are currently being dealt with within the OECD BEPS project.[390]

4.3.4. Summary

Like several other OECD member countries, Sweden is struggling with the erosion of its corporate income tax base through extensive international tax planning with related-party debt strategies. These harmful tax strategies are the result of a legal definition of debt that covers not only traditional debt instruments, but also derivatives with large moneyness. Because the characteristics of these derivatives are ever-changing between the characteristics of regular debt and the characteristics of the underlying (equity), the legal classification of these derivatives as debt or equity can never be carried out in a predictable way. Consequently, the classification problem related to debt and equity in Swedish corporate income taxation is, in principle, the same as the classification problem related to debt and derivatives in Swedish taxation of individuals' capital investments. In principle, the problem appears to be that legal form is used to classify financial instruments, the primary characteristic of which, according to the structure of the tax system, is their different financial risk.

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[388] See section 2.5.
[389] See e.g. Swedish Administrative Court of Appeal in Stockholm, Decision No. 6953-6957-11 (2012-11-13); and Swedish Administrative Court of Appeal in Gothenburg, Decision No. 1262-1264-13 (2014-04-02).
[390] See OECD 2013 (2) p. 17.

5. The problem and how it is handled

5.1. The lack of distinction between debt and derivative

In the previous sections, we have illustrated how difficult it is to separate derivatives and debt in a predictable way when legal form is the decisive criterion. This lack of a true distinction between debt and derivative is not only problematic in relation to the taxation of individual income from capital investments, but it is also a fundamental problem in Swedish corporate income taxation. How this problem threatens these two areas of Swedish income taxation and how this threat is handled by the tax legislator is presented in detail in this section.

5.2. Taxation of capital income

5.2.1. Flat tax on savings and investments

There is substantial legal uncertainty regarding the income tax treatment of capital losses from capital investments in structured "debt instruments" with a high credit risk or a risk related to commodities. This uncertainty is also evident in relation to derivative instruments on the same underlying asset – like a *contract for differences (CFD), wherein the seller pays the buyer the difference between current value of an asset and its value at contract time (or the buyer pays the seller if the difference is negative)*. As a complement to the conventional taxation as presented in this chapter, a new optional type of taxation of capital investments was introduced in Sweden in 2012: Flat tax on savings and investments – *Investeringssparkonto*.[391] In order to avoid confusion, we must stress that this flat tax differs from the tax on capital income in the Swedish dual-income tax system, which is often referred to as a flat rate tax (30%) on capital income.[392]

The flat tax on savings and investments diverge significantly from the traditional income taxation. Instead of calculating the tax object as income, the flat tax is levied on the market value of the tax subject's financial instruments.[393] It is reminiscent of the Netherlands' Box 3 income taxation system, and has many similarities, as well, with conventional wealth taxation, which was abolished in Sweden in 2007.[394] The flat tax can be described as accrual taxation of savings and investments, which has already being discussed as a possible system in relation to the tax reform of 1990.[395]

The primary reason for introducing the flat tax on savings and investments was the large number of incorrect tax assessments caused by the complex tax regulations on capital investment. Adverse locked-

[391] Prop. 2011/12:1 pp. 277–388 and Prop. 2012/13:24.
[392] See Section 4.1.2.
[393] For information on the calculation of the market value, see e.g. the opinion "Dnr/målnr/löpnr: 131 204738-14/111" SHOULD THIS WORD BE 'OPINION'?
of the Swedish Tax Agency.
[394] See e.g. Lodin, S-O (2009), pp. 114–121. About Swedish wealth taxation, see Henrekson, M. and Du Rietz (2014).
[395] See Section 4.1.2.

in effects of the realization principle was another reason for the new regulation. Legal uncertainty in the classification of debt, equity, and derivatives was not presented as a reason for the new legislation, however.

5.2.2. Classification issues

In order for flat tax to be applied to a financial instrument, it must be possible to establish its market value in a predictable way. Without a reliable, realistic value on the financial instrument, it remain in the conventional taxation system for capital income.[396] To secure this reliable value, the flat tax applies only on financial instruments that are traded on a regulated market or a multilateral trading facility (MTF), or that are a share in an investment fund governed by Swedish regulations.[397] These premises for classification directly refer to terminology in relevant EU Directives.[398]

Because existence of a reliable market value is the decisive criterion for being an object for flat taxation, there are no legal differences among equity, debt, and derivatives in this context. Thus, the classification issues mentioned previously do not exist in this system. In relation to the classification problems we analyzed in this chapter, the flat tax is therefore found to be successful. In the following section, it is argued, however, that this success comes at a relatively high price in regard to the underlying purposes of the income tax system.

5.2.3. Purposes of the tax system

As noted in Section 5.2.1, the purpose of the flat tax on savings and investments was to facilitate capital investments for individuals,[399] but the preparatory works do not specify any other purposes served by the flat tax. Thus, the flat tax appears to be a special case in the income tax system, which is, in itself, reason for criticism, because such legislation eventually leads to fragmentation of the system. In the referral for comments that preceded the law, that criticism was addressed in the following way: "…flat tax is incomprehensible, because it is based not on a general principle such as equal taxation, but is a special case of the taxation of income in this particular area."[400] The Swedish Government has not dealt with this criticism; nor has it considered similar opinions from several special interest groups. Perhaps by introducing an alternative, optional taxation of capital investment, the general underlying purpose of the capital income taxation – equal taxation – was eventually eliminated. The taxation of income differs, depending on which of the two systems are applied to the return from a financial instrument.[401]

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[396] The valuation problem in accrual taxation is thoroughly discussed in Shakow, D. (1986) pp. 1118–1168.
[397] Section 6, Lag (2011:1268) om investeringsparkonto, and Prop. 2011/12 pp. 288–296.
[398] The Markets in Financial Instruments Directive 2004/39/EC (MiFID), and The Undertakings for Collective Investment in Transferable Securities, Directive 2001/107/EC and 2001/108/EC (UCITS).
[399] Prop. 2011/12:1 p. 277.
[400] Prop. 2011/12:1 p. 278.
[401] See e.g. Starberg, D. and Gunne, C. (2012) p. 151. See also Section 6 below.

In the preparatory works to the conventional capital taxation, it is explicitly stated that the effective taxation of corporate investments is a highly prioritized purpose of the tax system.[402] Thus the conventional taxation of financial instruments treats returns related to corporate shares alike. By introducing the flat rate taxation, however, the government introduced inefficiency in the taxation of corporate investments. An explicit exclusion of certain corporate holdings from the flat tax fragments the taxation of corporate holdings.[403] This fragmented taxation of traditional equities and several other kinds of financial instruments – those not traded on regulated markets or MTFs, for example – provides competitive disadvantages for brokers of financial instruments who are disqualified from the flat tax. Within this deprived group fall brokers of CFD and *financial spread betting (leveraged trading)*, for example. Whether or not the introduction of the flat tax has had effects on corporate investments has, to our knowledge, yet to be analyzed.

Subsequent purposes of the conventional tax system were to limit potential tax credits and to eliminate classification issues between interest and capital gains and losses.[404] Because the flat-tax system uses accrual recognition of all income, in principle, tax credits due to insufficient timing principles do not exist within the system. Likewise, because there is only one kind of income recognized within the system – income from savings and investments – the classification of income is a non-issue. Thus, in isolation, the flat-tax system handles these two purposes well. It was also considered a strong alternative to the realization-based taxation in the tax reform of 1990.[405] The flat tax does not exist in isolation, however; the presence of the conventional taxation of capital income must be taken into account. Under these circumstances, it is likely that classification issues and tax arbitrage opportunities will exist – not within the two systems as such, but as a result of the existence of two optional systems, with different tax treatment of financial instruments.[406] An analysis of the situations and circumstances under which these potential legal nuisances exist is not within the scope of this chapter, however.

Finally it is worth mentioning that there will always be financial instruments with low and predictable returns: traditional debt instruments. By taxing the return from these instruments in the same way as returns from high-risk instruments, like equity derivatives, the effective tax on the return will be unequal, in favor of the more risky instrument.[407] Thus, to treat all financial instruments alike, the tax legislators must eventually abandon the goal of horizontal equity.

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[402] See Section 4.1.5.
[403] See Section 6.6.
[404] See Section 4.1.
[405] See Section 4.1.3.
[406] See Shakow, D. (1986) pp. 1166–1167.
[407] See sections 6.4 and 6.5.

5.2.4. Summary

The flat tax on savings and investments is alien to the conventional income taxation of capital investments. There is no stated ambition that this tax shall contribute to the fulfillment of the general purposes of capital income taxation systems, like equal taxation. And it does not. It does facilitate investments in financial instruments for individuals, however.

The design of the flat tax, in which no legal distinction is made between debt and equity, involves a new legal perception of financial instruments. In comparison to the conventional tax system, this untraditional view is more in line with the way these instruments are perceived in a pure financial context, as presented in Section 3. As a result, legal issues regarding the classification of financial instruments will likely decrease as legal certainty increases. Thus, within the flat tax system, none of the cases referred to in the presentation of the conventional tax system are relevant, and would never occur in the flat-tax context. The weakness of the flat-tax system is that it requires a tax object with an objective, reliable value. Thus, several over-the-counter, non-exchange-traded instruments must be excluded. This means that there will still be taxation of financial instruments in which the distinction between debt and equity is necessary. If the flat tax system becomes as popular as the Swedish Government wishes, however, it is only a question of time before the classification of financial instruments as debt and equity is an exception to the general rule whereby all financial instruments are treated alike. This development involves the ultimate abolishing of horizontal equity and tax incentives for risky investment in exchange-traded instruments.

5.3. The taxation of corporate income

5.3.1. Specific anti-avoidance rules

As an explicit response to the aggressive tax planning with related-party interest deductions, Sweden has introduced specific anti-avoidance regulations in two steps – in 2009 and in 2013.[408] Unlike most other specific anti-avoidance rules (SAAR) with the purpose of hindering this kind of aggressive tax planning (the earning-stripping rules in Germany, Norway, and Finland, for example), the Swedish rules classify interest payments as legal or illegal and taxes them based on that classification.[409] They have been criticized for their vagueness and for being in conflict with EU law – the fundamental freedom of establishment.[410] As a result, a large number of advanced rulings and precedent-setting court decisions on the application of these rules have been presented.[411]

[408] 24 Ch. 10a-10f §§ IL.
[409] See Kleist, D. (2014).
[410] See e.g. Hilling, M. (2012) and Ohlsson, F. (2014).
[411] See e.g. HFD 2011 ref. 90 I-V, and more than ten advanced rulings presented by the Board in 2014.

The classification of financial instruments as debt and equity is a legal problem that must be handled in order to deal effectively with the types of tax planning mentioned in this chapter. Furthermore, the tax system is drafted and designed based on the perspectives of personal income and a view that debt is a low-risk financial instrument.[412] These premises lead to the following considerations:

- A systematic interpretation of corporate income taxation must be conducted from the perspective of the owner (an individual) of the company, because corporate income taxation is an integrated part in individual's taxation of capital income.
- Taxation of individuals is based on the principle of horizontal equity.
- The tax system is structured on the assumption that debt is a low-risk financial instrument.

To deal with the legal problem based on these considerations could lead to the following argumentation: In order to achieve horizontal equity at the individual level, the return from high-risk investments must be taxed at the corporate level. Therefore, only returns from low-risk investments can be deducted at the corporate level. In practice, this leads to a risk-based classification of debt and equity in the corporate sector, which seems logical, given the structure of the system.[413]

This is not how the Swedish SAAR is constructed, however. This specific anti-avoidance rule deals with the legal problem – classification of financial instruments as debt or equity – by legitimating some debt instruments and illegitimating others, based on whether or not they have a true business purpose. Knowing that the legal problem is the result of negligence in referring to a financial instrument's financial risk when classifying it as debt or equity, it is evident that a classification norm based on business purposes could never eventually solve the problem. In fact, it appears as if it has created yet another problem.[414]

5.3.2. New corporate income taxation

To meet this criticism directed at the SAAR and to improve the corporate income tax system in general, the Swedish Government appointed a committee in 2011 to present an income tax system wherein the taxation of debt and equity in limited companies is equal. On 12 June 2014, the Swedish Committee on Corporate Taxation (*Företagsskattekommittén*) presented a proposal for new corporate income taxation.[415] The general purpose of the proposed tax system is to increase financial robustness in Swedish corporations and to prevent the Swedish corporate tax base from eroding through MNE's use

[412] See sections 2.6.
[413] The suggestion of such a solution is presented in Hilling, A. (2012). See also Ceryak, D. V. (1990) and Politio, A. P. (1998).
[414] See footnote 107.
[415] SOU 2014:40 Neutral bolagsskatt – för ökad effektivitet och stabilitet. See e.g. Lodin, S-O (2014) for a general presentation of the proposal.

of aggressive debt push-down strategies.[416] To achieve these purposes, the new tax system is designed to eliminate any difference in tax treatment based on corporate financing by debt or equity. Thus, there shall be economic neutrality between debt and equity within the corporate income taxation.

To achieve economic neutrality, the Committee suggested that corporations not be allowed to deduct financial net expenses. Thus, interest expenses that have historically had unlimited deductibility will only reduce the taxable result up to an amount equal to the tax subject's financial income. This mechanism, it is argued, eliminates tax incentives for economically unsound financing strategies, and removes any possibilities for eroding the Swedish corporate income tax base through the distribution of untaxed income in the form of interest expenses to foreign jurisdictions. The expected elimination of base erosion and the increase of taxable income in companies, which today are highly leveraged, enables a reduction of the corporate tax rate from 22% to 16.5%.

Unlike the SAAR, the proposal from the Committee on Corporate Taxation deals with the actual problem and solves it by treating all financial instruments equally. In relation to the underlying purpose of the tax system – equal taxation – it is only a second-best solution, however, because unlike a systematic interpretation of the legislation, the new legislation does not consider how income is taxed after it has been distributed to the individual owner of the company. Thus the proposed legislation, with a lowering of corporate income tax for most companies, actually leads to more unequal taxation, because the capital income will be taxed more favorably than labor income are. Furthermore, just as in the case with the flat tax on savings and investment, by treating all financial instruments equally, horizontal equity is abolished in practice.[417]

Consequently, just as in the case of individual capital taxation, the new proposed corporate income tax system has effectively dealt with the tax loophole of a classification of financial instruments, but the solution is not related to the tax system as such. The effect, therefore, is that the fundamental principles of the tax system are not observed. Rather, the two solutions work opposite to equal taxation, as illustrated in next section.

6. Unequal taxation

6.1. Horizontal equity

In Sections 2 and 4, we argue that the Swedish income tax system is founded on the principle of horizontal equity, and that this principle is satisfied when the classification of a financial instrument as debt and equity is conducted with reference to their financial risk. Furthermore, we argue that

[416] The members of the Swedish Corporate Tax Commission in DN Debatt, 2014-06-12.
[417] See Section 5.2.4.

horizontal equity is to be satisfied not only within the taxation of capital incomes, but also in regard to income from labor. Because the total tax on income from labor was approximately 60% when the tax system was designed, horizontal equity required capital income to be taxed at approximately 60% as well. Today the total tax on income from labor remains, for most labors, at approximately 60%, including payroll taxes.[418] Consequently, horizontal equity between capital income and income from labor is considered fulfilled in the following examples when capital income is taxed at 60% before it can be consumed by individuals.[419]

6.2. How to tax capital income equal to income from labor

Although the tax object is always computed on its nominal value, the relevant benchmark between wages and capital income is when the latter – capital income – is presented in terms of real income. This is so because the value of a capital investment is never adjusted in relation to inflation; in contrast, wages are inflation-adjusted in annual negotiations, so the value of labor can be said to be in recurrent salary negotiations. Consequently, Table 2 illustrates how the tax system is designed to target approximately 60% effective tax on real capital income. Because the presumed possible returns from debt and equity differ greatly in relation to the alleged inflation (twice as much and six times as much), it is necessary to treat them separately in order to meet the overall purpose of equal taxation.

Table 2. Taxation in accordance with the structure of the income tax system

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	4.00%	1.96%	61.20%

Note: The corporate income tax and the tax on capital income was 30% of the nominal income at the time the tax system was designed.

Source: authors

6.3. Taxing hybrid instruments as debt

Table 2 illustrates that high-risk return must be taxed at approximately 50% on the nominal value in order to reach the target of approximately 60% of real income. This is the reason equity income is subject to double taxation, whereas debt income is not. When the legal classification of debt comprises high-risk instruments such as derivatives with large moneyness, the effective tax on the nominal return from these instruments will remain at 30%. That results in a tax of less than 40% on real income, which

[418] Cf. Section 2.6.
[419] In the examples, the tax incentives for wages "earned income tax credit" (*jobbskatteavdrag*) are not taken into account.

is a significant departure from the target of 60%. Table 3 illustrates the consequences of the fundamental error of classifying high-risk financial instruments as debt.

Table 3. Single taxation of high-risk investments

Investment	Income	Corporate income tax	Tax on capital income	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	30.00%	30.00%	51.00%	2.00%	12.00%	9.80%	62.42%
Debt	Interest		30.00%	30.00%	2.00%	12.00%	9.80%	36.72%

Source: authors

6.4. Flat tax on capital

The flat tax on saving and investments dramatically lowered the capital tax on investments with high risk. Simple mathematics indicates that if an investment provides a better return than approximately 2%, the flat tax is more favorable for the investor compared to the conventional capital tax of 30%. The greater the return, the lower the effective tax. But because the double taxation of equity remains, the equality in taxation of capital income does as well, as long as only low-risk investments are classified as debt. Consequently, although the figures show equality between investments in debt and equity, the favorable treatment of capital income eventually brings the goal of horizontal equity between capital income and income from labor to an end.

Table 4. Flat tax on savings and investment

Investment	Income	Corporate income tax	Flat tax (ISK)	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	22.00%	5.23%	26.08%	2.00%	12.00%	9.80%	31.92%
Debt	Interest		15.68%	15.68%	2.00%	4.00%	1.96%	31.98%

Note: The flat tax is calculated on an average market value of 100,000 SEK during the tax year, thereby rendering a flat tax of 627 SEK in 2014. The corporate income tax rate is for 2014.

Source: authors

6.5. New corporate income taxation

The proposal of the Swedish Committee on Corporate Taxation treats income from debt and equity alike, also involving economic double taxation for interest income. Together with the lowered corporate income tax rate, the effective tax on real debt income targets the original goal of approximately 60% tax. It is noteworthy, however, that the effective tax on real debt income is much lower in the new system, compared to the conventional system, in pace with the return on the increase in debt. The lowered corporate income tax and the low flat tax on savings and investments have dramatically lowered the tax on equity income, however. The two new systems – flat tax and new corporate income tax – make the effective tax on real equity income less than half, compared to debt income and income from labor.

Table 5. Economic double taxation of debt and equity

Investment	Income	Corporate income tax	Flat tax (ISK)	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
Equity	Dividends	16.50%	5.23%	20.86%	2.00%	12.00%	9.80%	25.54%
Debt	Interest	16.50%	15.68%	29.59%	2.00%	4.00%	1.96%	60.36%

Note: The flat tax is calculated on the same bases as in Table 5.

Source: authors

6.6. Different kinds of equity

As illustrated in the tables, it appears that equity income is heavily favored in the future Swedish income tax system. Remember, however, that the favorable flat tax on savings and investments applies only to publicly traded financial instruments.[420] This means that several kinds of equity instruments fall outside the flat-tax regime and must be taxed in accordance with the less favorable conventional capital tax. Depending on the character of the equity instrument, the capital tax on equity is today 30%, 25%, or 20%.[421] Compared with the flat tax on savings and investments, even instruments subject to the most favorable capital tax, like close company equity, is much more heavily taxed. Thus, the flat tax on savings and investments has resulted in the tax incentive for close companies (20%) and unlisted companies (25%) being replaced with a tax incentive for investments in publicly traded companies (flat tax). In addition, the flat tax extends the unequal taxation within capital income.

Table 6. Unequal taxation of equity investments

Investment	Income	Corporate income tax	Individual income tax	Effecive tax	Inflation	Nomial income	Real income	Tax on real income
			Flat tax (ISK)					
Public company investment	Dividends	16.50%	5.23%	20.86%	2.00%	12.00%	9.80%	25.54%
			Captal tax					
Close company investment	Interest	16.50%	20.00%	33.20%	2.00%	12.00%	9.80%	40.64%

Source: authors

6.7. Summary

Whereas the tax on income from labour, including payroll taxes, remains at approximately 60%, the tax on real capital income will have decreased step by step to the all-time low of approximately 26%, if the proposed new corporate income tax rules are introduced. Given these dramatic changes, and digression from the tax system's fundament of equal taxation, it is startling how the tax-legislators avoid discussions on how the proposed legislative changes relate to equal taxation, in the preparatory works

[420] See Section 5.2.
[421] In this example, the tax incentives on investment deductions (*investeraravdrag*) presented in SOU 2012:3 and Prop. 2012/13:34 are not taken into account.

of the flat tax and in the proposal from the Committee on Corporate Taxation. We hope that such discussion will occur before additional major changes are made in the system.

7. Conclusions

The purpose of this chapter is to present the general trend in corporate income taxation, which exists in order to treat debt and equity alike, and to examine how it originates from the incapacity of previous tax-law making and its interpretation and application, concerning the legal classification of certain financial instruments. Our analysis of this issue can be summarized in the following eight points:

1. The structure of the Swedish taxation of capital income is risk-based. In this context, debt is assumed to be a financial instrument with returns that are just some percentage above inflation, and equity is a financial instrument with returns that could be much greater compared to debt.

2. By taxing low-risk financial instruments (debt) and high-risk financial instruments (equity) differently, it is possible to achieve equal taxation of capital income, and thereby achieve horizontal equity between capital income and income from labor.

3. The legal classification of debt and equity does not refer to the risk of financial instruments, however. Rather it focuses on the legal form, which is based on contractual considerations rather than financial risk.

4. Because financial risk is not considered when financial instruments are classified as debt or equity, the definition of debt has developed to include risky instruments, with contractual characteristics in concordance with the legal debt concept. From an economic point of view, these risky debt instruments are nothing but derivatives with large moneyness – high risk instruments.

5. Because the legal concept of debt has been extended to include risky financial instruments, the preferential tax treatment of debt can no longer be justified. Thus, what was originally a justified difference in tax treatment has turned out to be unjustifiable, because of the extended scope of the debt concept.

6. The legal problem is the wide legal definition of debt in a tax system the structure of which requires a relatively narrow definition of debt, covering only low-risk financial instruments. Instead of dealing with this problem by confining the legal concept of debt to cover only low-risk

instruments, however, the tax-legislators have kept the wide definition of debt and abolished the preferential tax treatment of debt.

7. By treating income from debt and equity alike, it is no longer possible to achieve the fundamental aim of equal taxation of capital income. Equal tax treatment leads to real income from traditional debt instruments; low-risk financial instruments will always be taxed more heavily compared to real income on traditional equity instruments – high risk financial instruments.

8. Horizontal equity within Swedish income taxation seems to be nothing but a memory.

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Chapter 8 – Convertible Debt Instruments in International Tax Law

Jakob Bundgaard[422]

1. Introduction

The financing spectrum for companies in need of capital contains several alternatives besides plain vanilla debt and equity. Well known hybrid instruments include convertible bonds, which seem to be an important alternative to the traditional financial instruments[423]. The first issuance of convertible bonds can be dated back to 1881 where J. J. Hill, a US railroad pioneer designed an innovative long term financing instrument without selling shares, since he found that the market would price the risk of his ventures too high[424]. The use of convertible bonds has increased significantly since then[425] and such instruments come in many variations[426].

Convertible bonds are considered hybrid instruments as they contain characteristics of debt as well as equity[427]. This may give rise to challenges from a tax law perspective and even more so in an international context, where more countries are involved which may classify and treat the instrument at hand differently. As a consequence double taxation may arise, but there may also exist possibilities of tax arbitrage.

2. Financial and contractual construction

2.1. Optional convertible bonds - Financial and contractual construction

2.1.1. In general

The notion of a convertible bond is a financial term arising in the financial markets[428]. Commonly, convertible bonds (convertible bonds, convertible debentures, convertible loan stock) are described as "unsecured fixed-interest bonds", giving the owner a right but not an obligation to convert the convertible bond into equity of the issuing company, and only under the fulfilment of certain specified

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[422] Managing director, PhD, CORIT Advisory LLP, Honorary professor, Aarhus University.
[423] See in general *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid Instruments, 2000, p. 1 et seq., *Brealey/Meyers/Allen*: Principles of Corporate Finance, 2006, p. 680 et seq., *Møller & Nielsen*: Konvertible obligationer i Danmark – Konstruktion, skat og prisdannelse, Nationaløkonomisk Tidsskrift, 1996, p. 24 et seq.
[424] Cf. *Coxe*: Convertible Structures: Evolution Continues in *Nelken* (ed.): Handbook of Hybrid instruments, 2000, p. 15.
[425] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 583, documenting an increased use over the past 25 years.
[426] Cf. *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid Instruments, 2000, p. 9.
[427] See *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid instruments, 2000, p. 1 ff, *Amby* in SR-Skat 2011, p. 301, and *Buur* i TfS 2011.80. The hybridity lies in the possibility to convert.
[428] See e.g. *Brealey/Meyers/Allen*: Principles of Corporate Finance, 2006, p. 680 et seq., *Tirole*: The Theory of Corporate Finance, 2006, p. 77, *Ross/Westerfield/ Jaffe/Jordan*: Modern Financial management, 2008, p.700 et seq., *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 582 et seq., *Pike & Neale*: Corporate Finance Investment Decision and Strategies, 1993, p. 283, *Fabozzi et al.*: Foundations of Financial Markets and Institutions, 1994, p. 426 and p. 541-546 and *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 43 ff.

terms and conditions[429]. From a financial perspective convertible bonds can be seen as a combination of a common bond and a call option (or a warrant)[430]. The call option on the yield of the issuing company is described as ”an integral part of equity ownership”[431]. Alternatively, convertible bonds are described as to contain ”equity kickers”[432]. If conversion does not occur full repayment of the principal should take place. Convertible bonds are initially considered debt but may at a later stage turn into equity. Whenever the bondholder exercises the option this does not result in any cash payment since the bond is exchanged into shares in the issuing company.

A variety of convertible instruments exist. At the basic level a distinction is made between "optional convertibles"[433], ”reverse convertibles”, "mandatory convertibles" and ”contingent convertibles”[434].

As a supplement certain exotic convertibles also occur, including LYONs and Toxic convertibles. The latter giving the holder a right to shares at a fixed price. Any decrease of the value of the issuing company will accordingly only affect the existing shareholders but not the convertible bondholders. *Exchangeable bonds* resemble traditional convertible bonds but with the important difference, that the conversion right will give the holder a right to convert into shares of another company than the issuing company. “*The Ratchet Convertible*” is a specific form making the conversion ratio dependent on the performance of the issuing company.

2.1.2. Typical terms and conditions in optional convertibles[435]

Interest

Convertible bonds typically hold a lower interest rate than plain vanilla bonds. This may be beneficial to growth companies with massive capital costs[436]. The lower interest rate reflects the conversion right of the holder. Convertible bonds can be issued with a term stating that the interest will be increased at a future date, if the bonds have not been converted (Convertible Debt With Enhanced Interest)[437].

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[429] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 8.
[430] Cf. *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid instruments, 2000, p. 2, *Brealey/Meyers/Allen*: Principles of Corporate Finance, 2006, p. 680, *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 582, *Møller & Nielsen*: Konvertible obligationer i Danmark – Konstruktion, skat og prisdannelse, Nationaløkonomisk Tidsskrift, 1996, p. 25.
[431] Cf. *Strnad*: Taxing Convertible Debt, 2002, p. 2.
[432] Cf. *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 44.
[433] *Coyle*: Hybrid Financial Instruments, 2002, p. 22 et seq., divides convertible instruments into 6 broad categories: Conventional convertibles, Low-premium convertibles, Discount convertibles, Rolling-premium put convertibles, Single-premium put convertibles, Liquid-yield option notes (zero-coupon convertibles).
[434] Cf. *Trier et al*, 734 PLI/Tax, 2006, p. 197 et seq. (p. 203).
[435] See e.g. *Strnad*, id., p. 20 et seq., stating ”stylized facts” on convertible bonds. See moreover *Lewis & Verwijmeren*: Convertible Security Design and Contract Innovation, 2009.
[436] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 8, *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 44 and *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid instruments, 2000, p. 3.
[437] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 32.

Term

As with other types of loan financing the duration varies significantly ranging from short term loans to perpetual convertible debt. Normally, convertible bonds are issued with a fixed maturity/repayment date[438]. Repayment shall take place at par value at the fixed date. In practice repayment often takes place prior to maturity, i.a. due to exercise of a call option for the issuer to repay or due to exercise of a put option allowing the investor to demand repayment[439].

Conversion right

Convertible bonds present a right for the holder to convert the bonds to equity under certain conditions[440]. The conversion right shall be exercised either (1) at a fixed date or (2) at either one of several fixed conversion dates, or (3) in a conversion period.

Convertibles are normally converted into a fixed number of shares. The *conversion ratio* (which may vary from year to year) expresses the number of shares, which the bonds can be converted into[441]. The *conversion price* expresses the price of the shares which the bonds can be converted to and is typically fixed at the time of the issuance. When convertible bonds are issued the conversion price is higher than the actual market price of the shares at the time. The difference in price between the convertible bonds and the shares, which it can be converted into, is called ”the conversion premium”. From an investor perspective an attraction is the possibility that the share price will increase and eventually exceed the conversion price[442].

The ratchet convertible

Hybrid financial instruments serve a purpose for investors (e.g. Venture capitalists) in risky businesses[443]. People considering investing in start-up or other risky companies face challenges of illiquidity and information shortfall. To alleviate these difficulties, venture capitalists have created what may be seen as innovative hybrid financial instruments. By using convertible bonds some of the problems may be solved by making the conversion ratio dependent on the performance of the company[444]. Named the "ratchet" convertible, the securities feature an option that converts into a declining ratio of company shares as the rate of return on the investment exceeds a certain ceiling, or converts into an even greater number of shares as the investor's rate of return falls below a given floor. Compared with the return on a convertible note with a fixed rate of conversion, the return on a ratchet

[438] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 9.
[439] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 9.
[440] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 11.
[441] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 11.
[442] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 16.
[443] See *Longhouse:* Making the Line a Gap: Edgar's Treatment of the Debt-Equity Boundary, Journal of Canadian Tax law, 2002, Vol. 50, No. 1, p. 242.
[444] Id., p. 243.

convertible is less exposed to the fortunes of the company: it pays more than a fixed-rate convertible in respect of a less successful company but less than a fixed-rate convertible in respect of a company that is very successful. The entrepreneur is given ever-increasing upside incentive; the VC investor is given downside protection[445]. This is an example of how a difficult problem of conflicting interests between parties aggravated by imperfect information can be addressed by using a hybrid financial instrument[446].

Call option for the issuer

Convertible bonds are often seen to include a call option for the issuer to redeem the bonds for a certain premium[447]. Such option is however, subject to so-called ”call protection”, disallowing the holder to exercise for a certain period of time. In case of exercise the investors may choose whether to hand over their bonds or to convert. An exercise of the call option can thus force a conversion if the share price is sufficiently high.

2.2 Mandatory Convertibles, Reverse Convertibles and Contingent Convertibles

Certain convertible instruments include terms resulting in mandatory or very likely conversion into equity. Such instruments are referred to as ”mandatory convertibles”[448], which may be described as follows:

”… in their most basic form, an issuer will issue a debt security or preferred stock that is mandatorily convertible within a specified number of years in to the issuer’s own common stock…”[449].

And moreover:

”…Unlike the buyer of traditional convertible securities, who in effect purchases a call option on the underlying common stock, the buyer of mandatorily convertible securities is in effect selling a put option to the issuer…”[450].

Such instruments are often cons idered to be closer to equity than debt since the repayment will take place in shares and since the ”downside protection” is minimal and may be limited to the ongoing

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[445] Id.
[446] The example is used by *Longhouse*, id., to demonstrate that there is more to the market than arbitrage.
[447] See *Strnad*, id., p. 10, *Ross/Westerfield/Jaffe/Jordan*: Modern Financial Management, 2008, p. 708, *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 584, *Coyle*: Hybrid Financial Instruments, 2002, p. 19 et seq, and *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 44.
[448] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 592, *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 48 and *Pajak*: Mandatory Convertible Bonds as Special Hybrid Financing Instruments, 2008, Diplomarbeit, University of Vienna) and *Marshall*: Will Mandatories Catch on in Europe, Euromoney, 2003, Vol. 34, Issue 405, p. 8.
[449] Cf. *Johnson & McLaughlin*: Corporate Finance and the Securities Laws, 1997, p. 750.
[450] Cf. *Johnson & McLaughlin*: Corporate Finance and the Securities Laws, 1997, p. 761.

interest payment (if any) alone. In addition mandatory convertibles are in many cases treated as equity for accounting purposes and for rating agency purposes[451].

A known variation is the ”reverse convertible”, characterized by granting the issuer a conversion right rather than the holder and allowing the investor different choices with respect to repayment[452].

The distinct feature of reverse convertibles is described as follows:

“…under the contract the issuer, at maturity, has the choice of either repaying, in cash the holder the face value of the bond or transferring to the latter a certain number of shares of a specified third party corporation…”[453].

Such terms are particularly variable for the issuer, if e.g. the share price would drop significantly, resulting in a possibility to repay the debt with cheap stock. Hereby the debt could be reduced in situations where ”financial distress” seems threatening in the horizon[454]. Several variations of reverse convertibles exist, including such where the holder is allowed to convert into shares of a group company or into shares of a portfolio company of the issuer or even into completely unrelated companies.

Three general characteristics of mandatory convertibles can be identified:

(1) Mandatory conversion at the maturity of the convertible,

(2) Capped or limited appreciation potential compared to the underlying stock,

(3) The dividend yield on a mandatory convertible is typically higher than on the underlying stock[455].

Mandatory convertibles have gained a larger scope in the US than in Europe, but even the European market is expected to increase[456]. During recent years certain development of mandatory convertibles have been seen in the form of exotic instruments such as PERCS (Preferred Equity Redemption

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[451] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 592 and *Johnson & McLaughlin*: Corporate Finance and the Securities Laws, 1997, p. 750.
[452] See *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 47 et seq. and *Rotondaro* in DFI 2000, p. 258 et seq. That the definition is not fixed is clearly seen from the contribution by *Feder* in DFI 2001, p. 230.
[453] See *Rotondaro* in DFI 2000, p. 258 et seq.
[454] Cf. *Brealey, Meyers, Allen*: Principles of Corporate Finance, 2006, p. 685 and *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 595 and *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 47.
[455] See *Chemmanur, Nandy & Yan*: Why Issue Mandatory Convertibles? Theory and Empirical Evidence, available at: www.ssrn.org, current version March 14, 2006, p. 1 et seq.
[456] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 593, pointing out that the instruments *“…appeal to investors looking for high yield and capital appreciation, although they have less downside protection than standard convertible bonds. As a result we see interest from equity funds and outright investors but the main investors are hedge funds because they are able to significantly offset stock exposure…”*.

Cumulative Stock)[457], DECS (Debt Exchangeable for Common Stock eller Dividend Enhanced Convertible Securities)[458], PRIDES (Preferred Redeemable Increased Dividend Equity Securities. Mandatory convertibles are also used in private transactions. Commonly used instruments include CPECs (Convertible Preferred Equity Certificates)[459] and ORAs (Obligations Remboursables en Action) as seen in French law[460].

The rationale underlying the issuance of mandatory convertibles has only to a lesser extent been analyzed in the economic theory[461]. A possible description of the reasons for companies to engage in the issuance of mandatory convertibles may be the following:

"…we find that it is indeed firms facing a smaller extent of information asymmetry but a larger probability of financial distress that issue mandatory convertibles: those facing a larger extent of information asymmetry and a smaller probability of financial distress issue ordinary convertibles…"[462].

[457] From Morgan Stanley.
[458] From Salomon Brothers.
[459] The instruments vary in their design and are typically based on detailed contractual documentation. The following features are common: The CPEC is interest bearing with a market interest rate. The interest will only be paid out in so far the management of the issuing company decides so and if the company will not be insolvent as a consequence. CPEC are non-terminable, unless the issuing company is liquidated. CPECs have priority over share capital but subordinated all other debt. The principal of the CPEC can only be repaid if the issuing company does not become insolvent as a consequence. After a certain period of e.g. 30 years the issuer has a right to convert the CPEC into shares. The investor can only exercise the right to convert if the loan in case of default, and if the issuer does not want to repay the principal including interest rolled into the principal. The issuer can also decide to call a conversion into shares. In case the issuer has obtained a gain or received dividends from other companies, this will trigger a repayment, unless the issuer decided to convert into share capital. In case of the latter the CPEC shall be repaid at the highest amount of the nominal amount of the CPEC including interest payments rolled into the principal or a computed value of the value of the loan based on the Net Asset Value of the company as if the loan constituted part of the company's equity.
[460]The instruments vary in their design and are typically based on detailed contractual documentation. An ORA is typically defined as a bond which must be settled with shares in the issuing company. An essential feature of an ORA is the mandatory conversion, whereby the ORA-holder cannot require repayment in any other way. If the ORA-holder does not carry out the share subscription by the planned capital increased this will trigger an obligation to pay a contribution to the issuing company corresponding the amount which has not been transferred to the ORA-issuer according to the agreement. The ORA-holder can demand settlement at any time. The ORA-issuer is obliged to secure a capital increase corresponding to the total ORAs. An ORA gives right to interest payments and typically has a stated term of 7-10 years. Moreover the ORA-holder will have significant rights on the issuing company, ensuring that the company does not carry out different transactions without reserving a shareholder's rights for the ORA-holder, including capital increases, distributions, issuance of new bonds, any merger involving dividends. ORA-holders are treated as shareholders in case of a capital decrease. In Danish law an ORA was classified in TfS 2003.895 LR. The Tax Assessment Council stated that the ORA should not be considered share capital for Danish tax law purposes.
[461] A thorough attempt is: *Chemmanur, Nandy & Yan*: Why Issue Mandatory Convertibles? Theory and Empirical Evidence, available at: www.ssrn.org, current version may 6, 2004. See also *Arzac*: PERCS, DECS, and other Mandatory Convertibles, Journal of Applied Corporate Finance, 10, pp. 54-63 and the same: PERCS, DECS and other mandatory convertibles in *Chew (ed.):* The New Corporate Finance: Where Theory Meets Practice, 1999.
[462] Cf. *Chemmanur, Nandy & Yan*: Why Issue Mandatory Convertibles? Theory and Empirical Evidence, available at: www.ssrn.org, current version march 14, 2006, p. 35.

Mandatory convertibles have also been described as a way to obtain "Back-Door Equity Financing"[463] which since the 1980'es has provided highly leveraged or financially exposed companies a possibility of obtaining equity (Tier 1 capital)[464]. Mandatory convertibles can minimize the negative information consequences attributed to the issuance of equity instruments under asymmetrical information. On the other hand the issuer will ensure the investor a yield which exceeds what would normally be expected in dividends[465].

2.3 Contingent Convertible instruments ("CoCo's")

One specific form of additional Tier 1 capital is Contingent Convertibles (CoCo)[466]. CoCo's are debt instruments typically issued by banks or other regulated financial institutions, which contain certain characteristics to optimize the adequacy position and are typically listed on an official stock exchange[467]. Contingent capital would act as equity and provide a cushion to convince depositors and other creditors that their money is safe[468]. Essentially the term contingent capital is used very generally to describe a kind of put option enabling the issuer to issue new equity at pre-negotiated terms.

CoCo's are typically perpetual. The repayment is at the discretion of the issuer and optional. The issuer undertakes to repay the bonds after 30 years, provided its core capital is sufficient at that moment and subject to the consent of the regulator. The issuer also undertakes, on a best-effort basis, to raise new replacement capital if on such date its existing core capital is insufficient. The interest is at a fixed rate or a floating plus margin. Moreover, payment of interest is at the full discretion of the issuer. If interest is not paid, no dividend may be paid by the issuer until the next interest payment date ("dividend stopper"). Interest will not be paid and will be cancelled if on the interest payment date the distributable reserves of the issuer are insufficient. CoCo's are direct, unsecured and subordinated debt obligations. The conversion feature implies that mandatory (automatic) conversion takes place upon the occurrence of a conversion trigger. Hereby it is seen than CoCo's are in fact mandatory convertibles. Another

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[463] Cf. *Arzac*: Back-Door Equity Financing: Citigroup's $7.5 billion Mandatory Convertible Issue", Colombia University, July 10, 2008.
[464] Id, p. 2.
[465] Id., p. 6.
[466] The background may be the issuance of a notice from the Basel Committee dated 13 January 2011, setting out requirements for banking institutions to follow, cf. Basel Committee: "Minimum requirements to ensure loss absorbency at the point of non-viability". In the notice, it was directed that all non-common Tier 1 and Tier 2 instruments must provide that, at the option of the local banking authority, the instrument will be written off or converted into common equity in the event the local banking authority determines the bank would otherwise become "non-viable". According to *Hammer, Chen & Carman* in DFI 2011, p. 97, CoCos are the instruments issued to date that are closest to satisfy this provision. See also *Calomiris & Herring*: Why and How to Design a Contingent Convertible Debt Requirement, 2011 (http://ssrn.com/abstract=1815406) and *Zähres*: Contingent Convertibles – Bank Bonds take on a new look, Deutsche Bank Research, May 23, 2011.
[467] See the Introduction to the Comparative Survey, DFI 2011, p. 96. The following generalized description of CoCo features is based on this introduction. Several financial institutions have issued their own versions of CoCo, including Lloyds Banking Group, Rabobank and Credit Suisse, cf. *Hammer, Chen & Carman* in DFI 2011, p. 97. See *Green et al.*: Hybrid Securities: an overview, PLC, Capital Markets multi-jurisdictional guide 2012/13 with an overview of the specific features of a number of specific issues.
[468] See *Green et al.*: Hybrid Securities: an overview, PLC, Capital Markets multi-jurisdictional guide 2012/13.

possibility is that conversion is at the option of the issuer. Conversion triggers typically relate to the issuer's capital ratio falling or threatening to fall below a certain threshold[469]. Triggers could be based on national financial criteria as well as on an individual institution's condition. There is no conversion at the option of the bond issuer.

2.4 Warrant loans and option loans (Bond cum warrant)

It is commonly seen to add warrant to debt or to package the sale of bonds with stock as a sweetener. Such packages are often referred to as warrant loans, warrant bond loans or option loans. They are a combination of a "straight bond" and a separate warrant[470] making them equity like debt instruments. Warrant loans are internationally considered among the best known HFIs[471].

The remuneration for a warrant can be paid in two ways:

- (1) An open agio (defined as the difference between the higher issuing value and the lower redemption value of the debenture bond) is granted by the creditor, while the nominal interest payments are in line with the conditions of the capital market.
- (2) A hidden agio (which consists of lower interest rates compared to the rates on the capital market) is granted by the creditor, while the issuance and redemption value are equal to the par or nominal value[472].

There is a close resemblance to convertible bonds and the two types of financial instruments seem to be considered close substitutes. The economic literature bears witness of this by dealing with the instruments under one[473]. Occasionally, convertible bonds have been issued in periods in time, where warrant bonds could not be issued by companies[474]. It seems fair to assume that the economic reasoning underlying the issuance of warrant loans to a great extent resemblance the rationale behind the issuance of convertible bonds.

The use of warrant loans or option loans give rise to several tax considerations, i.a. whether to treat warrant loans as one or more instruments and questions regarding valuation and possible allocation of acquisition price.

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[469] See also *Hammer, Chen & Carman* in DFI 2011, p. 97.
[470] Cf. *Rahim, Goodacre & Veld*: Wealth Effects of Convertible Bonds and Warrant-bond Loans: A Meta Analysis, WP, 2011, p. 3, http://ssrn.com/abstract=1687098 and *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 46
[471] See e.g. *Theisen & Wenz* in *Michielse (ed.):* Tax Treatment of Financial Instruments, 1995, p. 185 et seq. for a general description in German law.
[472] See e.g. *Theisen & Wenz* in *Michielse (ed.):* Tax Treatment of Financial Instruments, 1995, p. 185.
[473] See e.g. *de Roon & Veld*: Announcement Effects of Convertible Bonds Loans and Warrant-bond Loans: An Empirical Analysis for the Dutch Market, Journal of Banking & Finance, Vol. 22, Issue 12, December, 1998, p. 1481 ff. and *Rahim, Goodacre & Veld*: Wealth Effects of Convertible Bonds and Warrant-bond Loans: A Meta Analysis, WP, 2011, http://ssrn.com/abstract=1687098.
[474] Cf. *Amby* in SR-Skat 2011, p. 301.

3. The financial decision on investing and issuing convertible bonds

It is often described as a puzzle why investors would want to invest in convertible bonds and warrant loans[475]. The fascination lies in the fact that it consists of a low risk instrument (a traditional bond) in combination with a high risk instrument (a call option). For investors with different tolerances of risk one would assume that it would be more relevant to invest in the instruments separately (bonds for the more risk averse and warrant for the investors with a greater appetite for speculation)[476].

Finance theory has developed different explanations for the issuance of convertible bonds[477]. One view is that convertible bonds represent a form of "backdoor equity financing" or delayed issuance of shares[478]. Moreover, using convertible instruments may prevent "dilution".

Convertible instruments have been described as a cheaper method of debt financing, since the coupon on convertibles is lower than fixed interest bonds with the same term[479]. Convertible bonds may also offer a better cash flow which would match the cash flow of the issuing company[480].

In a tax law context it has been assumed that convertibles may ensure interest deductibility on the basis of an instrument which is intended to be equity[481]. Generally speaking the role of the tax system on the financing decision in the context of convertible instruments should be carefully considered[482]. This includes the deductibility issue, which may cause convertible instruments to have a lower after tax cost than equity[483].

Convertible instruments may have a signaling effect, whereby the issuing company is not affected as negatively as if further equity instruments were issued[484]. Certain US empirical studies demonstrate that the issuance of equity would affect the yield significantly more negative than if convertible bonds were issued[485]. *Strnad* argues that the most successful overall explanation of the issuance of and the terms

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[475] Cf. *Strnad*: Taxing Convertible Debt, 2002, p. 6 ff.
[476] Cf. *Klein*, 123 U. Penn L. Rev. , 1975, p. 547 et seq., (p. 555-561).
[477] See *Brealey/Meyers/Allen*: Principles of Corporate Finance, 2006, p. 682 et seq., *Ross/Westerfield/Jaffe, Jordan*: Modern Financial management, 2008, p. 704 et seq., and *Coyle*: Hybrid Financial Instruments, 2002, p. 64 et seq.
[478] See *Strnad*, id., p. 3 with references, *Ross, Westerfield, Jaffe, Jordan*: Modern Financial management, 2008, p. 708, *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 587, *Coyle*: Hybrid Financial Instruments, 2002, p. 64 et seq. and *Eswar* : Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid instruments, 2000, p. 3.
[479] *Ross, Westerfield, Jaffe, Jordan*: Modern Financial Management, 2008, p. 706 rejects that convertible bonds are cheaper or more expensive that straight debt or equity, and concludes the following: *"…In general, if a company prospers, issuing convertible bonds will turn out to be worse than issuing straight bonds and better than issuing common stock. In contrast, if a company does poorly, convertible bonds will turn out to be better than issuing straight bonds and worse than issuing common stock…*". See moreover *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 577
[480] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 587.
[481] See *Strnad*, id., p. 3 with references.
[482] Cf. *Miller*: Financial Innovation: The Last Twenty Years and the Next, Journal of Financial and Qualitative Analysis, 1986.
[483] Cf. *Coyle*: Hybrid Financial Instruments, 2002, p. 66.
[484] Cf. e.g. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 587.
[485] Cf. *Strnad*, id., p. 15.

used in convertible bonds is the signaling effect in light of the information asymmetry[486]. The author concludes the following:*"…The basic idea is that firm insiders issue convertible bonds and call them in response to their inside information concerning future performance…"*[487].

According to *agency theory*, convertible bonds may prevent conflicts between shareholders and creditors, and the use of convertible bonds can be used to avoid "risk shifting" from shareholders to the creditors[488]. Another explanation is that convertible bonds and warrant loans can be used if a company/project is surrounded by significant uncertainty. Convertible bonds can reduce the temptation of the management in highly leveraged companies to engage in risky ventures in order to increase the value for the shareholders to the disadvantage of the creditors, since the creditors has the right to convert into equity.

Convertible instruments are seen to be applied in smaller and often more speculative companies where ordinary debt financing may be too expensive in terms of a very high coupon[489]. It seems well documented that investors are often more willing to take on risks if they also get "a piece of the action"[490]. In other words convertible bonds are used where it is expensive or difficult to assess the risk of a project or when the investors are worried that the management of the issuing company will not act in the interest of bondholders[491].

A practical summary of the respective benefits to issuers and investors from using convertible instruments is developmed by *Eswar*: Hybrid Instruments: Advantages and Disadvantages in *Nelken* (ed.): Handbook of Hybrid instruments, 2000. With respect to the issuer the following is pointed out, p. 3:

- Reduced interest cost since Convertible Bonds typically have lower yields than equivalent debt securities.
- Full tax deduction of coupon payments made on outstanding Convertible bonds when compared to dividend payments on equivalent outstanding stock, which is non-deductible.
- Equitization of debt, which occurs when Convertible Bonds are converted.

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[486] Id., p. 16 et seq., mentioning the Nyborg-Harris-Raviv signaling theory, which is the basis of the author's tax policy analysis.
[487] Cf. *Strnad*, id., p. 4 et seq., and p. 16.
[488] Cf. *Vernimmen*: Corporate Finance – Theory and Practice, 2005, p. 586.
[489] *Brealey, Meyers, Allen*: Principles of Corporate Finance, 2006, p. 683.
[490] See *Brennan & Schwartz*: The Case for Convertibles, Journal for Applied Finance 1, 1988, p. 55 et seq.
[491] Cf. *Brealey, Meyers, Allen*: Principles of Corporate Finance, 2006, p. 684 and *Ross, Westerfield, Jaffe, Jordan*: Modern Financial management, 2008, p. 707 and *Jostarndt*: Financing Growth in Innovative Industries: Agency Conflicts and the Role of Hybrid Securities – Empirical Evidence from Nasdaq Convertible Debt Offerings, 2002.

- Reduction of debt to equity ratio when Convertible Bonds are converted.
- Forward sale of common stock at a premium price to market price.

With respect to the investor the following is pointed out, p. 5:

- A positive differential in yield over common stock.
- Participation in the upside potential of the common stock since a holder can convert a bond into stock at any time.
- Downside protection provided by the fixed-income value of the bond in case the stock plummets.
- Seniority to preferred stock and common stock in case of default.

4. Domestic Tax treatment of Convertible Debt Instruments

4.1. Comparative overview

Convertible bonds have given rise to tax law challenges in many countries[492]. In many countries common practice seems to favor debt classification of convertible bonds until conversion[493]. This also indicates that the mere right to convert debt into equity does not in most jurisdictions lead to a reclassification into equity, albeit the conversion right in some countries is considered a characteristic that is taken into account in the debt-equity classification[494]. Consequently, other equity traits may lead to equity classification for domestic tax purposes. In fact as stated by *Helminen*, the higher the probability of conversion, the greater is the likelihood of reclassification as equity[495]. Moreover, the classification of convertible bonds also depends very much on whether the country in question applies an integration approach or a bi-furcation approach.

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[492] See for a comparative overview *Laukannen*: Taxation of Investment Derivatives, 2007, p. 320 with an overview of the taxation of convertible bonds in the United States, United Kingdom, Germany, Finland and Sweden. A comparative survey on the overall issues on hybrids including convertibles was published in DFI 1999 September/October and November/December. French law is described by *Renard & Rouch* in DFI 1999, p. 260 et seq., German law is described by *Trapp* in DFI 1999, p. 321 et seq., Spanish law is described by *Ramirez & Carraño* in DFI 1999, p. 268 et seq. Dutch law is described by *Arjan & van der Linde* in DFI 2001, p. 45 et seq. Australian law is described by *Orow* in DFI 2001, p. 208, p. 208 et seq. (p. 214) and Belgian law is described by *Lamon, Weynants & Berckmans* in DFI 2001, p. 143 et seq. (p. 155 et seq.). A multijurisdictional overview is provided by *Freshfields Bruckhaus Deringer*: Convertible Bonds – A multijurisdictional tax survey, 2009. This overview also contains information regarding mandatory convertibles.

[493] See as illustrative *Edgar*: The Income Tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 52 and *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 192. A similar result is reported by *Freshfields Bruckhaus Deringer*: Convertible Bonds – A multijurisdictional tax survey, 2009 with respect to Austria, Belgium, France, Germany, Netherlands, Spain and US (with a caveat regarding mandatory convertibles which may be classified as equity). A bifurcation approach is reported in the UK, Germany and Austria.

[494] See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 192.

[495] Id.

In *Norwegian* law it has been widely debated whether convertible bonds should be treated as a single instrument or in accordance with a bifurcation approach. The question has been settled with the Supreme Court decision dated 8th December 2011[496], where the Court decided that convertible bonds should be treated as a single instrument (a bond) until conversion. Based on this the taxpayers could not obtain the tax exemption for the warrant part of the convertible instruments in question[497].

In *Swedish law* convertible bonds are generally treated as shares (delägerrätter)[498]. If the convertible bonds are issued in a foreign currency the convertible bonds are treated as debt[499]. Subscription of convertible bonds does not trigger any tax consequences[500]. Interest payments paid according to the convertible bonds are taxed as any other taxable interest income. Any gain or loss realized upon a sale of the convertible bond is taxable according to generally applicable principles on the computation of capital gains[501]. The conversion of convertible bonds is not considered a taxable event[502].

Finnish law has adopted a bifurcation approach whereby convertible bonds are divided into the current earnings part and the capital gains part[503].

In *Dutch* law convertible debt is traditionally considered debt until conversion[504]. The fixed interest therefore constitutes business expenses for the issuer. In Dutch law, the Hooge Raad has ruled that convertible bonds express a legal relationship for the holder against the issuing company, which is very similar to that of a shareholder[505]. Accordingly, Hooge Raad found that the Dutch Participation exemption applied to a holder of convertible bonds. This implied that the benefit for a parent company arising from the conversion of a convertible loan issued by a subsidiary should be classified as a benefit derived from (future) share ownership. Dutch commentary finds this concept of future share ownership to be indeed new[506].

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496 See HR-2011-02285-A, (Sak nr. 2011/869), *Industrinvesteringer AS and Hafslund Venture AS.*
497 See for commentary prior to the final decision *Matre*: Studier i det skatteretslige rentefradraget – med særlig sikte på hybridfinansiering av aksjeselskaber, 2010, p. 186 et seq. *Matre* suggests that convertible bonds should be considered equity instruments if the warrant element of the convertible instrument makes up the most significant part of the total value of the instrument.
498 See to this effect *Dahlberg*: Rente eller kapitalvinst, 2011, p. 575, *Laukannen*: Taxation of Investment Derivatives, 2007, p. 334 et seq. with references and *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 299 et seq.
499 *Dahlberg*, op.cit., p. 576, argues in favor of a clearer legislation within the area.
500 See *Dahlberg*, op. cit., p. 577.
501 See 44 kap. IL and *Dahlberg*, op.cit., p. 586.
502 See *Dahlberg*, op.cit., p. 591.
503 See *Laukkanen*: Taxation of Investment Derivates, 2007, p. 330.
504 See for Dutch law *Michielse* in Tax Treatment of Financial Instruments, 1996, p. 248 et seq., *Jansen & van Kasteren* in DFI 2008, p. 175 et seq. (180 et seq.) and *Kok* in Derivatives 2014, p. 204.
505 See Hooge Raad case no. 43.643, dated 12 October 2007. The case is analyzed in details by *de Gunst & Rumpen* in Derivatives, 2008, p. 2 et seq.
506 See *de Gunst & Rumpen* in Derivatives, 2008, p. 6.

The *United Kingdom* applies a bifurcation approach to qualified hybrid instruments splitting such instruments into the host contract and the embedded derivative[507]. The bond of the instrument will be treated within the specific UK loan relationship regime whereas the embedded derivative (the call option), within the derivative contract regime[508].

4.2 US Federal Tax Law

The traditional debt/equity classification issue also applies to convertible bonds[509]. Convertible debt is normally treated as a "single property" in the form of debt until conversion[510]. After conversion the instrument becomes equity. Convertible bonds are not governed by any particular Code provision which leaves the description of current applicable US law a matter of various Code provisions, Treasury Regulations, judicial decisions and IRS pronouncements to determine the appropriate tax treatment of convertible instruments[511]. In terms of classification, convertibility does not alone lead to equity classification but is merely a factor which is included in the general debt/equity test. As stated in IRS Notice 94-47, convertible debt, which includes terms that the holder may be expected to convert the debt into shares, may be treated as equity for tax purposes.

Participation in the success of a corporation is clearly an equity-feature and as such essential to equity status, but not necessarily inconsistent with a creditor-debtor relationship[512]. This holds true if the participation takes the form of a right to receive a portion of the debtor's above-target earnings or an option to convert debt into equity, as seen with convertible bonds[513]. Traditional convertible instruments have a substantial equity feature, but only on the upside. Because the holder has the right to demand payment of principal at maturity, these notes generally have been respected as debt. If an instrument is convertible, it is more likely to be classified as equity. The conversion option may be explicit in the instrument's terms or may be implied when the corporate issuer has the discretion to repay a debt instrument by use of its own stock. On the other hand, the IRS has ruled that a convertible instrument that promises the holder only 60% of its initial investment and is not converted is equity because this feature was calculated primarily to ensure conversion into stock[514].

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[507] See *Laukannen*: Taxation of Investment Derivatives, 2007, p. 326.
[508] Id.
[509] If the instrument is reclassified into equity, the usual characteristics of equity apply, including the nondeductibility of the interest payments, see *Bittker/Eustice*: Federal Income Taxation of Corporations and Shareholders, Vol. 1, 2006, p. 4-115.
[510] See *Bittker/Eustice*: Federal Income Taxation of Corporations and Shareholders, Vol. 1, 2006, p. 4-115 et seq., *Helminen*: The Dividend Concept in International tax Law, 1999, p. 298.
[511] See *Laukannen*: Taxation of Investment Derivatives, 2007, p. 320.
[512] See *Bittker & Eustice*, id., p. 4-28, *Hammer* id, p. 338, *Garlock*, id., p. 1017. The IRS has stated that the presence of a sum certain payable at maturity is a sine qua non of debt treatment under the IRC, see FSA 199940007 and Notice 94-47.
[513] See *Bittker & Eustice*, id., p. 4-28, *Burilovich* in The Tax Adviser, Dec. 1, 2006, p. 3.
[514] See Rev. Rul. 83-98, 1983-2 C.B. 40, 41.

If however, exercise of a conversion right is virtually certain, e.g. because of specified ratios (mandatory convertibles), the debt features of the instrument may be brushed aside as camouflage[515]. A convertible bond differs from a bond with a warrant principally in that, whereas exercise of the warrant brings in new cash but leaves the corporation indebted on the bond, conversion extinguishes the bond indebtedness[516]. However, it confers none of the attributes of immediate stock ownership and does not impose an equity-like risk on the holder.

Convertible bonds are non-severable from a financial point of view, since the holder must forfeit his creditor position if he wishes to become a shareholder[517].

For US federal tax purposes a conversion of convertible bonds has been treated as a non-taxable event[518]. This is well established since 1920[519]. The conventional theory is that gain or loss is not realized on the conversion[520].

The rather complicated technical rules regarding convertible bonds are analyzed in tax literature[521].

4.3 German Tax Law

Convertible bonds are commonly used in the German market (Wandelanleihen)[522]. The tax treatment of convertible instruments follows the treatment in accounting and there is no specific provision regarding the issuance of convertible bonds[523].

Prior to the conversion convertible bonds are classified as debt for tax purposes[524]. Both convertible bonds and option loans may be classified as equity if they also include other equity characteristics[525]. As a consequence of this classification the convertible bond produces interest income which is taxable for

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515 See Rev. Rul. 83-98 and *Bittker & Eustice*, id., p. 4-29.
516 See *Plumb*, id., p. 435.
517 See *Bittker/Eustice*: op. cit.
518 See *Bittker/Eustice*: op. cit., p. 4-120, *Garlock*: Federal Income Taxation of Debt Instruments, 2007, p. 10,009.
519 Id., p. 4-121.
520 Id., p. 4-120.
521 See *Trier et al*.: The Taxation of Convertibles after Revenue Ruling 2002-31, PLI, Tax Strategies for Corporate Acquisitions Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings, 2006. It is stated that over the years a number of more esoteric variations of convertibles have been issued, reflecting both the particular financial conditions at the time and the remarkable ingenuity of investment banker. See also *Strnad*: Taxing Convertible Debt, Stanford Law School, John. M. Olin Program in Law and Economics, WP 236, 2002 and New York bar Association Tax Section – Report on the taxation of Straight and Contingent Convertible Debt, Report no. 1022, 2002.
522 See *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 185 et seq., *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 328.
523 See *Trapp* in DFI 1999, p. 323. See also Briesemeister and Freshfields
524 See *Trapp* in DFI 1999, p. 323, *Theisen* in Tax Treatment of Financial Instruments, 1996, p.187, *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 299.
525 *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 299.

the holder and deductible for the issuer[526]. The same applies to option and warrant loans. Income and expenses have to be allocated over the lifetime of the bonds.

The issuance of warrant loans and convertible bonds do not result in a realization of (taxable) capital gains or losses either at the level of the creditor or the German resident debtor company[527].

The conversion from bonds to shares is a non-realization event, and no tax consequences are realized for the investors[528]. For corporate holders all current profits and capital gains deriving from the bond's purchase and sale or redemption are subject to tax as business profits[529].

4.4 Danish law[530]

4.4.1 Introduction

The great variations of convertible instruments put emphasis on the requirements for the tax legislation in place governing convertible bonds. This is even more so, if the overall goal is to obtain neutrality. The task is made difficult due to the fact that certain instruments, albeit somewhat identical, serve different financial objectives. Accordingly it is essential to assess the impact of the tax legislation on the issuance of convertible instruments, since such issuances can be largely driven by non-tax concerns and efficiency improving purposes[531].

The first systematical contribution in Danish law was white Paper no 856, 1978, chapter 12, which seems to have formed basis for all subsequent considerations regarding the tax treatment of convertible bonds.

Convertible bonds are now governed by ABL § 1, stk. 1 and KGL § 1, stk. 4[532]. Historically convertible bonds have been treated as claims, warrants or as both only to find its current place as covered by the scope of the ABL[533]. The first time specific legislation was introduced in Danish tax law was in 1981[534].

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[526] See *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 189, *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 299.
[527] *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 187.
[528] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 303 et seq., and *Laukannen*, op. cit., p. 329.
[529] See *Trapp* in DFI 1999, p. 323.
[530] See for an extensive domestic analysis of Danish law: *Bundgaard*: Konventionelle konvertible instrumenter (I) SR-Skat 2012, p. 266 et seq. and (II) p. 341 et seq.
[531] Cf. *Strnad*, id., p. 4.
[532] Specific considerations are applicable to employees, cf. TfS 1988.286 LR and for commentary *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 260.
[533] Cf. with respect to the historical development *Led-Jensen*: Beskatning af lønindkomst, 2000, p. 255 and *Jakobsen* in R&R 2000 SM, p. 194. See in general for an overview of the taxation of convertible bonds Betænkning nr. 856, 1978, p. 184 et seq., *Banner-Voigt et al*: Aktieavancebeskatning, 2006, p. 265 et seq., *Ramskov*: Intern selskabsomstrukturering, 2001, p. 567 et seq., *Christiansen*: Beskatning af aktionærer, 1998, p. 190 et seq., *Berning*: Finansieringsret, 1977, p. 198 et seq., the same in UfR 1975 B., p. 262 et seq., and in UfR 1976 B., p. 42 et seq., and contra *Strobel* in UfR 1976 B., p. 16 et seq., and in UfR 1976 B., p. 53 f, in SpO 1974, p. 92 et seq. And hereto *Andersen* in SpO 1974, p. 326 et seq, and *Amby* in SR-Skat 1990, p. 218 et seq., and in SR-Skat 2011, p. 301 et seq.
[534] Cf. § 8 in the historical ABL, cf. act no. 295 dated 10.6. 1981.

Since the first specific legislation regarding convertible bonds it seems that the rules have been constantly changing.

Danish law has never governed the details of how convertible bonds in different scenarios should be taxed.

The notion of a convertible bond has never been directly defined in the legislation. The 1981 wording did not contain any support in the delineation of the notion of convertible bonds[535]. It was merely stated what typically characterized convertible bonds. Accordingly, it was stated that convertible bonds are normally characterized by the status as creditor of the investor. Moreover, it is stated as an essential characteristic that the investor can become a shareholder under certain conditions, but that there is no obligation to convert the bond. As a consequence it has been acknowledged that convertible bonds constitute a hybrid instrument.

Since then Danish tax law now seems to apply a definition as follows: *A convertible bond is defined as a bond issued by a public- or private limited company giving the investor a right to convert the claim on the company into shares in the issuing company or to require repayment in cash. The conversion right applies for a fixed period of time. Finally, it is required that the conversion right reflects a right in substance.*

If such a right is not part of the instrument in question it will be treated merely as a claim subject to the KGL[536]. The definition is noteworthy. On the one hand it is a definition and on the other hand the description gives the impression that it is merely a description of typical terms in convertible bonds. The criteria have been further developed in TfS 2009.67 SR where the Danish tax authorities promoted the following criteria: (1) a conversion right; (2) a right to claim repayment in cast, (3) no obligation for the holder to convert. These criteria seem to fit into the existing company law and tax law nomenclature.

The above definition applies to convertibles issued by Danish as well as foreign companies. In terms of foreign companies this may give rise to certain challenges when a convertible instrument issued in a foreign company contains terms which are not specifically included in the Danish definition, see e.g. SKM 2008.962 SR[537].

Apart from the existing classification issues concerning convertible bonds, questions also arise regarding the tax authorities' respect of the instrument for tax purposes. As appears from case law this is far from the case in all situations. See TfS 1989.164 LSR. The Supreme Court case in SKM 2010.123 H

[535] Cf. FT 1980-81 B, sp. 1207 et seq.
[536] Cf. the preparatory remarks to act no. 440 dated 10.6. 1997 (L 195), Circular no. 137 dated 19.7. 1994, par. 11, preparatory remarks to L 78 2005, re. § 1, sec. 3. and Juridisk Vejledning C.A.5.17.6.
[537] See also *Amby* in SR-Skat 2011, p. 301 et seq.

involved a convertible bond with an agreed interest rate of 25% and duration of 3.5 months. The Supreme Court upheld the lower court decision according to which the convertible bonds were perceived as an integral part of an overall tax scheme, which should be assessed as a whole and not on a step by step basis. According to the courts the bank did not take on any risk and the arrangement in total was designed solely with the purpose of obtaining tax advantages, i.e. interest deductions and tax exempt capital gains. Consequently, the interest deduction was denied by the Supreme Court.

4.4.2 Interaction with company law

The notion of a convertible bond as applied in Danish tax legislation does not contain a clear reference to company law nomenclature. Whether or not convertible bonds for tax purposes should be understood in accordance with the definition found in company law is still debated. The issue is mostly relevant when dealing with convertible bonds which are issued by foreign companies. In my view the correct interpretation is that no fixed requirement exists to interpret convertible bonds the same way for tax law and company law purposes[538]. The question has been relevant in the following situations:

- **Convertible instrument contains a term requiring payment of additional capital upon conversion.** In TfS 2003.113 LR this issue was at stake. Moreover, the decision is the first in Danish case law where the notion of a convertible bond as such is considered. A taxpayer was offered convertible bonds in the German parent company of the Danish subsidiary where the individual was employed. A stated term was that the owner of the convertible bonds upon conversion should pay in additional capital of a certain amount per share. The Danish Tax Assessment Counsel was i.a. asked to confirm that the instrument could be considered a convertible bond for Danish tax purposes. The Danish tax Assessment Council stated that the term regarding additional payment deprived the instrument its character of being a convertible bond for Danish tax purposes[539]. The decision has been harshly critizised in the legal debate by *Vinther* and *Werlauff*[540]on the basis that a reclassification from the private starting point was made and that the decision is based on a misinterpretation of the underlying company law provisions. Similarly *Buur* has concluded in TfS 2011.80 that the decision is in conflict with the

[538] Cf. *Bundgaard* in TfS 2003.523 and in TfS 2003.995 and in Skatteret og Civilret, 2006, p. 1024 et seq. The interaction between private law and tax law in the specific context of convertible bonds has been debated in light of TfS 2003.113 LR. See to this effect *Vinther & Werlauff* in TfS 2003.345 and contra *Bundgaard* in TfS 2003.995. This issue was also debated in *Bundgaard* in TfS 2003, 523 and *Vinther & Werlauff* in TfS 2003.705. Since then the debate was continued by *Feldthusen & Graff Nielsen* in Festskrift til Ole Bjørn, *Susanne Pedersen et al. (eds.),* 2004, p. et al. After the repeal of ABL § 1, stk. 3, which largely widened the scope of the Danish capital gains in the Shares Tax Act to include all convertible instruments, the situation now again depends on how the notion is defined. For practical purposes convertible bonds for company law and tax law purposes should mostly be considered parallel. *Buur* has described the relationship in TfS 2011.80 as the company law definition is similar to the tax law definition.

[539] Indirect support to the decision is found in the remarks of the Tax Tribunal in TfS 2002.41 LSR, where it is stated that the a characteristic for convertible bonds is that the amount for which share subscription has been done is the amount which is paid in at the subscription of convertible bonds.

[540] Cf. *Vinther & Werlauff* in TfS 2003.345.

company law rational underlying the current SL § 171, and moreover argues that a requirement to pay in additional capital upon conversion does not change the fact that the requirements of being a convertible bond for tax purposes continues to be fulfilled.

- **The impact of on-demand terms in a convertible instrument.** In SKM 2010.774 SR the Danish Tax Board was asked to confirm that a convertible bond for company law purposes should also be considered a convertible bond for tax law purposes[541]. The instrument at hand was issued in accordance with the underlying company law legislation. The particular feature in question was on-demand terms, according to which the creditor at any time could demand repayment of the debt or conversion. The Tax Board stated that the existence of on-demand terms did not violate the tax law treatment as a convertible bond according to § 1, par. 4 of the Capital Gains on Shares Act. The result seems correct.

- **The importance of the absence of company law procedures.** A more recent decision involved the absence of company law procedures in the context of convertible bonds[542]. The case concerned the question whether a loss in connection with the waiving of a claim on a foreign joint venture company. The loan document contained the following provision*"…The Lender has the right at any time to convert the Loan to equity in the Borrower…*". Referring to this term the Danish authorities found that the instrument at hand should be classified as a convertible bond for Danish tax purposes. On the other hand the company argued that the instrument should not be classified as a convertible bond, since a number of formal company law procedures which are part of Danish company law were absent according to Jordanese law. The Danish Tax Tribunal stated two requirements which should be fulfilled in order to classify as a convertible bond: (1) there should be a claim on the debtor, which can be repaid in cash where the creditor has a real right to demand conversion of the claim into share capital. If these requirements are not fulfilled the instrument should be classified as a claim according to KGL. On the basis hereof and the actual loan documents the Danish tax Tribunal considered that the requirements were fulfilled in order to qualify as a convertible bond. The basis for this conclusion was that there was a real right to conversion into share capital of the borrower. It was not considered decisive that the loan documents did not contain specific rules regarding the conversion price. Accordingly, the Tax Tribunal concurred with the tax authorities in stating that the instrument at hand should be treated as a convertible bond. With this decision the Danish tax Tribunal has correctly indicated

[541] See for commentary *Buur* in TfS 2011.80.
[542] Cf. Decision from the Danish Tax Tribunal dated 30.9. 2011 (j.nr. 10-02495).

that the existing formal company law procedures prescribed in Danish company law are not to be seen as an integral part of the tax law definition of a convertible bond.

4.4.3 On the substance requirement

As already mentioned the Danish tax law definition of convertible bonds contains an explicit substance requirement. This is based on the reasoning if the conversion right is an illusion this would in fact reduce the instrument to a claim and as a consequence the claim should be treated as a claim for tax purposes[543]. A convertible where the substance requirement is not fulfilled will be treated as a claim subject to KGL[544]. Seemingly, the background is that convertible bonds according to historical legislation would be treated particularly beneficial compared to claims where capital gains were taxable whereas gains on convertible bonds could be tax exempt[545].

Apart from this starting point the legal sources does not contain any clarification as regards the substance requirement. Tax literature has stated that its assessment is concretely based on the actual terms and conditions of the instrument in question[546]. Moreover, it is stated that the relevant starting point should be a "likelihood of conversion" measurement[547]. According to this point of view the substance requirement would be fulfilled if the parties at the time of entry would consider it unlikely, that the conversion right would be used. As an example this could be the case if the exercise price would significantly exceed what is considered a likely future market price of the underlying shares[548]. Another example would be situations, where the convertible bond should be repaid at a premium, which significantly exceeds possible gains from the exercise of the conversion right[549].

4.4.4 Integration or bifurcation?

Whether an integration or bifurcation approach is used in Danish tax law is a general issue regarding the tax law treatment of financial instruments[550]. According to Danish tax law convertible bonds are generally treated as one instrument (an integration approach)[551]. However, in certain situations a bifurcation approach seems to have been applied. This was the case in TfS 1999.410 LR where the Danish Tax Board stated that a convertible bond is an instrument, which contains a bond and a warrant. The case concerned the valuation of convertible bonds issued for employees, and the tax board stated that the total value of the instrument should be meassured as the sum of the value of both

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543 Cf. FT 1996/97, A, p. 4145 and *Ramskov*: Intern selskabsomstrukturering, 2001, p. 568 et seq., *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 264, fn. 319.
544 Cf. *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 264.
545 See e.g. for this explanation SKM 2007.464 SR.
546 Cf. *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 263.
547 Cf. *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 264.
548 Id.
549 Id.
550 In general regarding this question see *Dyppel* in TfS 2012.303.
551 See *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 256.

instruments[552]. Similarly, a bifurcation approach is seen in TfS 2002.41 LSR, stating that salary taxation could take place if the value of the bond and the warrant exceeds the loan[553]. Finally, SKM 2003.7 LR is an example of a bifurcation approach of a convertible bond into a bond and an option.

4.4.5 Tax treatment of the investor

The below contains a description of the Danish tax treatment of an investor in convertible bonds[554], which is followed by a description of the tax treatment of the issuer of convertible bonds.

The mere issuance of convertible bonds does not trigger any tax consequences for the issuing company as well as for the investor according to Danish tax law.

Repayment of a convertible bond is considered parallel to disposal of the instrument, which can take place to the issuing company or a third party. ABL is applicable if cash repayment takes place at the initially agreed repayment date and at the initially agreed repayment price[555].

With the Supreme Court case in TfS 1997.389 H it was finally settled in Danish law that the holder of a convertible bond is free to choose repayment of the bond at par value even if the price of the shares significantly exceed par value even where the holder of the bond is also the majority shareholder in the company[556]. The only reservation taken by the Supreme Court is that this may not apply if economic benefits are shifted between shareholders, e.g. if some shareholders obtained repayment at par value while others converted into share capital.

Convertible bonds are considered sold or repaid, when the due date arises[557].

Repayment of a convertible bond at a premium or prior to the due date is also considered a sale of the convertible bond[558]. If on the other hand repayment takes place prior to the due date or at the due date but at an amount exceeding the agreed principal of the loan, this is considered a sale of the convertible bond to the issuing company subject to LL § 16 B (i.e. dividend treatment)[559].

The conversion as such does not trigger any Danish tax implications[560]. Conversion prior to the agreed exercise date is not considered a disposal of the convertible bond. However, an economic benefit

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552 Previously, the issue was dealt with in TfS 1992.62 TSM. See e.g. *Ramskov*: Intern selskabsomstrukturering, 2001, p. 594.
553 For commentary see JUS 2001, nr. 52. A similar result is found in TfS 1990.334 T&S, regarding a subscription at a premium.
554 The following assumes that the investor is subject to corporate income tax.
555 See *Amby* SR-Skat 2011, p. 302 and *Buur* in TfS 2011.80.
556 For commentary see *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 269 et seq., *Bjørn* in SR-skat 1997, p. 252 et seq., and *Mou Jakobsen* in RR 1997 SM 261.
557 Cf. *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 271.
558 A recent case illustrating this is SKM 2010.774 SR. Cf. *Banner-Voigt m.fl.*: Aktieavancebeskatning, 2006, p. 270 and *Amby* in SR-Skat 2011, p. 302.
559 Cf. the preparatory remarks to act no. 310 dated 25.5. 1987 and Bill L 195 (act. No. 440 dated 10.6. 1997), p. 969 et seq.
560 Cf. for an early statement of this FT 1985/86 A sp. 592. See also TfS 1990.333 T&S, *Banner-Voigt et al*: Aktieavancebeskatning, 2006, p. 269, *Amby* in TfS 2011, p. 301 et seq., and *Buur* in TfS 2011.80.

received by the conversion might trigger tax consequences, cf. TfS 1988.286 LR. In TfS 1990.333 LR and TfS 1990.334 LR it was found that the conversion as such did not trigger any consequences but that the subscription of shares led to taxation if the subscription of shares was carried out at a premium. According to ABL § 29 A the time of acquisition of shares acquired by a conversion of convertible bonds is set to the conversion date.

Any gain or loss on convertible bonds is treated according to ABL, cf. ABL § 1, par. 3[561]. Shares received upon conversion may be classified as subsidiary shares or as group shares which are tax exempt. However, the convertible bonds cannot be classified as subsidiary shares or as group shares, cf. ABL § 4 A, par. 7 and ABL § 4 B, par. 3. Convertible bonds held by corporate investors are per se considered taxable portfolio shares[562]. This is likely to include dividends occurring as a consequence of premature repayment of a convertible bond, which are also considered taxable.

As a consequence, any gain on a convertible bond is taxable and losses are deductible. With the objective of preventing double deductions a specific provision applies which sets forth limitation on loss deductibility on intra group convertible bonds. cf. ABL § 9, par. 5.

4.4.6 Tax treatment of the issuer

All existing tax provisions in Danish tax law on the treatment of convertible bonds concern the treatment of investor owning the convertible bonds. The issuing company is not subject to these provisions.

The issuance of convertible bonds does not trigger any tax consequences for the issuing company as well as the investor. From the perspective of the issuer the convertible bond is a loan and the subscription amount is considered loan proceeds. The issuer is treated similar to the issuer of shares, with the result that the issuer is not taxed on gains and is not allowed a deduction of any loss connected to the issuance, repayment or conversion of the convertible bond.

KGL is not applicable to convertible bonds according to the specific exception in KGL § 1, stk. 4. As a consequence KGL does not apply to any potential gains or losses realized upon issuance or repayment. The issuer is not taxed according to ABL. Consequently, the tax treatment of debtor depends on the generally applicable tax rules in the State Tax Act[563]. This conclusion is not stated explicitly anywhere but follows from the interaction between the different rules[564]. Capital gains and losses on convertible bonds are consequently taxed according to SL §§ 4-6. In concreto SL § 5 should apply, according to which

[561] Cf. also *Amby* in TfS 2011, p. 301 et seq., and *Buur* in TfS 2011.80.
[562] See *Amby* in SR-Skat 2011, p. 303, stating that the background is the fact that convertible bonds are not covered by the Parent/Subsidiary Directive.
[563] Cf. *Banner-Voigt m.fl.:* Aktieavancebeskatning, 2006, p. 271.
[564] See also to this effect TfS 1992.539 LR.

gains are tax exempt and losses are non-deductible unless the convertible bonds are acquired as part of professional trading. In other words there is no statutory authority to tax capital gains in accordance to SL § 4 and no possibility to deduct potential losses realized upon issuance[565]. In sum the issuer is not taxed and is not allowed any deduction upon issuance, repayment or conversion[566].

Convertible bonds may carry an interest payment, which can be designed in various ways. Interest payments are treated as other interest payments according to Danish tax law. Interest payments are deductible according to SL § 6e, in so far the payment qualifies as an interest payment and subject to the specific interest limitation provisions applicable in Danish law.

As a starting point tax payers can design financial instruments according to the freedom of contract. However, this does not mean that there are no boundaries in the design of convertible bonds and the yield thereon between interest and capital gains. As an example SKM 2007.471 LSR should be mentioned, where the Danish tax tribunal set aside a specific arrangement between a company and its majority shareholder. In this case the shareholder borrowed 2.3 MDKK to his company, which was paid out at a value of 65 due to a 2% interest rate. The reclassification resulted in taxation of 6% of the amount actually paid out to the company[567]. The reclassification took place as a deemed interest payment according to LL § 2 (the arm's length principle). The capital gain which should be crystallized upon repayment after 10 years was considered a deemed dividend payment. This decision is quite interesting in the sense that the starting point of the freedom of contract is questioned. The Danish Tax Tribunal did not recognize the fact that the creditor's remuneration partially is found in the low initial value according to which the payment took place. The total effective remuneration seems to have been arm's length[568].

In the view of this author tax payers should still be able to decide how to design the total remuneration on convertible bonds. Zero-coupon convertible bonds are an example of this. Consequently, the above case law from the Danish tax tribunal should be viewed as a standalone case or directly as a wrong decision. In line with this it is seem in later case law that the Danish Tax Board has recognized zero-coupon terms, if a built in capital loss in sum will lead to an arm's length remuneration, cf. SKM 2010.864 SR. The Supreme Court statement in SKM 2012.92 H, should however, be taken into consideration in terms of the interpretation of LL § 2.

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[565] See FT 1996/97 A, p. 4146 and *Led-Jensen*: Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer, 2000, p. 278.
[566] Cf. Bill L 195, 1996-1997 and moreover *Skouby* in TfS 1998.290 and *Ramskov*: Intern selskabsomstrukturering, 2001, p. 591.
[567] Cf. *Bjørn* in SR-Skat 2007, p. 424 et seq., assumes that the decision is based on the Danish substance over form doctrine.
[568] See *Wittendorff*: Armslængdeprincippet i dansk og international skatteret, 2009, p. 511, for critizism. Wittendorff states that the decision is wrong and a misinterpretation of LL § 2.

5. Domestic Tax Treatment of Mandatory Convertible Bonds and Reverse Convertibles

5.1. Comparative considerations

Apparently it seems that only few countries have legislated directly on mandatory convertibles and reverse convertibles and moreover case law on the classification of mandatory convertibles is scarce. In a recent decision from the *Swedish* Supreme Administrative Court (Hägsta Forvaltningsdomstolan) dated 14 February 2014 it was decided that a mandatory convertible should be classified as equity and that the interest paid should be non-deductible[569]. The case involved the issuer of a convertible bond, who upon maturity was entitled to repay the principal either in cash, or through newly issued shares. According to IFRS the instrument was recognized as equity for accounting purposes. The Court initially stated that the instrument at least in form would fall under the definition of debt for tax purposes. However, the Court found that the accounting treatment could serve as a relevant starting point also when determining the classification for tax purposes. The Court highlighted the fact that the instrument did not represent an obligation for the issuer to repay the principal out of its own funds, as it could choose to repay either in cash or by newly issued shares. This feature was considered deviating from what would normally be considered debt for tax purposes. The Court rules that the convertible bond should be considered as equity for tax purposes, and thus that the interest expenses on the bond should be non-deductible.

In the Indian LMN case (2008-TIOL-18-ARA-IT (10 October 2008) case the Indian Authority for Advance Rulings (AAR) was presented with a "compulsory convertible bond (CCD)"[570]. The AAR held that the payment made to a foreign company up to the date of conversion of CCDs into equity shares will be treated as interest income for the foreign lender and will be taxed as such in India under both the provisions of the Indian Income tax Act and article 11(2) of the India-United States income tax treaty. According to the AAR the income cannot be regarded as dividend income. In another more recent case the Delhi High Court the court held that proceeds from the sale of CCD's are taxable as interest income and not as capital gain (subject to capital gains tax) according to the applicable India-Mauritius tax treaty[571].

[569] See Högsta Förvaltningsdomstolans dom 14 Februari 2014, Mål nr. 4745-13.
[570] See *Sanghvi*: Ruling on Characterization of Income from Convertible Debenture: A Hybrid Instrument, in DFI 2009, p. 74 et seq.
[571] See High Court of Delhi in Zaheer Mauritius v. DIT [2014] 47 taxmann.com 247 (Delhi) and for commentary *Jhabakh* in Derivatives & Financial Instruments, 2014 (Volume 16), No. 5, 25th September 2014.

Dutch commentary finds mandatory convertibles to constitute equity from the moment they are issued[572]. However, this analysis does not apply to reverse convertibles, which are still considered debt until conversion[573].

Laukkanen provides an overview of country practices with respect to the tax treatment of reverse convertibles in the US, UK, Germany, Finland and Sweden[574].

The tax treatment of reverse convertible in the UK also seems fairly unclear[575]. Reverse convertibles are treated as interest generating instruments in German law. In Sweden the instruments are treated as generating interest income and capital gains upon conversion[576]. Dutch law has been reported to classify reverse convertibles (RCN) as a loan, which produces interest. Such loans have been treated in accordance with an integration approach[577].

5.2 Federal US Tax Law

Mandatory convertibles are classified in US law on a case by case basis according to the generally applicable debt-equity test. Accordingly, the tax treatment of mandatory convertibles depends on the existence of equity features in the specific mandatory convertible instrument. In an early Rev. Ruling the IRS concluded that the mandatory convertible in question created a debtor-creditor relationship[578]. Later the IRS issued guidance describing that instruments that on balance are more equity-like are unlikely to qualify as debt for federal tax purposes[579]. More recently certain guidance from the IRS indicates that mandatory convertibles may not be treated as debt for tax purposes[580].

In the US the classification of reverse convertibles is far from clear. This is based on the fact that contingency seem to be an equity component. Accordingly, there is a non-established practice[581].

5.3 German Tax Law

Mandatory convertibles also seem to be surrounded by great uncertainty in German tax law in terms of the correct tax treatment[582].

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[572] See *Kok* in Derivatives 2014, p. 204.
[573] Id.
[574] See *Laukannen*: Taxation of Investment Derivatives, 2007, p. 337 et seq.
[575] See *Laukannen*: Taxation of Investment Derivatives, 2007, p. 342.
[576] See *Laukannen*: Taxation of Investment Derivatives, 2007, p. 347 and Dahlberg: Ränta eller kapitalvinst, 2011, p. 593 et seq.
[577] See *Bierlaagh* in ET 1999, p. 332 and *Rotondaro* in DFI 2000, p. 258 et seq. (p. 259).
[578] See Rev. Rul. 85-119 and *Kramer*: Financial Products: Taxation, Regulation and Design, Vol. 3. § 49.05.
[579] See Notice 94-47.
[580] See *Kramer*: Financial Products: Taxation, Regulation and Design, Vol. 3. § 49.05 with detailed analysis of administrative practice.
[581] See Feder in DFI 2001, p. 245.
[582] See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 263 et seq. and *Häuselmann & Wagner*: Steuerbilanzielle Erfassung aktienbezogener Anleihen: Options-, Wandel-, Umtausch- und Aktieanleihen. BB 2002 20. November p. 2431-2436 *and Häuselmann*: Die Steuerliche Erfassung von Pflichtwandelanleihen, BB, 2003, heft 30, p. 1531 et seq.

According to EStG § 20, 1 number 1 and KStG § 8, 3, sentence 2 hybrid financial instruments are reclassified as equity if both remuneration payments participate in the current profits of the capital borrower and the capital repayment participates in the liquidation proceeds of the capital borrower.

For German tax purposes reverse convertibles have been considered loan producing instruments where the received payments in the hands of the holder have been treated as interest payments[583]. The loss upon redemption suffered by the reverse convertible note holder, when the issuers redeem the note at less than the face value, is not relevant for German income tax purposes.

5.4 Danish Tax Law[584]

Mandatory convertibles and reverse convertibles are not governed by any speficic tax provision in Danish tax law. Consequently, such instruments are taxed in accordance with generally applicable tax rules. Unfortunately, it is impossible to conclude anything in general terms since the final outcome is dependent of the terms and conditions applicable to the instrument in question. Quite often mandatory and reverse convertibles contain several non-plain vanilla characteristics at the same time, which may lead to complications in the qualification process. Even with respect to mandatory convertibles in their simplest form great uncertainty is present in the absence of any clear case law.

Prior to 2005 the classification of mandatory convertibles and reverse convertibles in Danish tax law would depend on the general tax applicable rules. Several possible outcomes seem to have been available.

One such outcome to consider is mandatory convertibles as share-like instruments subject to ABL. This possibility is not really convincing since the existence of a share seems to require formally registered share capital for Danish tax purposes[585]. In TfS 2003.895 LR the Tax Board did not consider a French ORA to be a share for tax purposes.

What seems to be the only available source of interpretation is a non-publicly available decision from the Tax Assessment Council, according to which mandatory convertibles were treated as atypical warrants, where the subscription value was paid in advance prior to the issuance of the shares. On this basis the yield in the concrete case was not considered interest payments for tax purposes. Rather, the yield was considered a premium, where the investor is remunerated for taking on the risk that lies in the early payment of the subscription value several years ahead of the issuance of shares. Warrants are subject to ABL as far as the investor is concerned, cf. ABL § 1, stk. 4. On the other hand the Tax

583 See *Rotondaro* in DFI 2000, p. 258 et seq. (p. 259) with further references.
584 See for a more detailed analysis in Danish *Bundgaard*: Finansiel Innovation som skatteretlig udfordring - Mandatory Convertibles & Reverse Convertibles i dansk skatteret, in Kerzel (ed.) Festskrift til Jan Pedersen, 2011, p. 35 et seq.
585 Cf. TfS 1996.603 V and TfS 1984.189 Ø.

Assessment Council stated that interest payments did not trigger any tax consequences for the issuing company since the payment was considered an equity transaction. This is most to be understood in a way whereby the ongoing yield is not taxed and the future acquisition price of the shares is increased, resulting in a decreased future capital gain.

Non-publicly available has also dealt with mandatory convertible bonds involving a lesser degree of certainty on the share subscription. In such a case the instrument was classified as subordinated loan. In such a situation the yield was considered interest payments for tax purposes.

The above historical uncertainty was partially abolished in 2005, cf. act. No. 1413 dated 21.12. 2005 (L 78). With this act ABL was changed to include a specific provision regarding all convertible instruments. Accordingly, since 2005 the scope of ABL was broadened significantly regarding convertible instruments and in the view of this author would also include mandatory convertibles and reverse convertibles under the scope of ABL § 1, par. 3. This question was however, not clarified before another legislative amendment took place.

By act no. 530 dated 17.6. 2008 (L 181) ABL § 1, par. 3 was abolished. The Danish Ministry of taxation had seemingly concluded that the provision included mandatory and reverse convertibles. The background behind the amendment seemingly was that there was a risk that certain securities unintendedly were included under the scope of multiple tax laws with the possible effect that the tax payers could choose to apply the act which would be most beneficial.

It was stated in the preparatory remarks following the amendment that the repeal of the specific provision, that other types of non-traditional convertible bonds are subject to taxation according to KGL. This statement is very problematic, since an instrument can only be included under the scope of KGL, if the instrument constitutes a claim/debt according to the applicable nomenclature. As a consequence the statement is far to generalizing and does not fully reflect the complexity of hybrid financial instruments. In the view of this author the correct approach is to apply the above described interpretation where each concrete mandatory and reverse convertible should be thoroughly analyzed in light of the different alternatives[586].

[586] In a later decision in TfS 2009.67 SR further light was shed on the topic and the decision gives hope that concrete assessments will apply in future cases. The hope is based on the statements made by the Tax Board where it was mentioned that a concrete assessment can lead to a classification of mandatory bonds as warrants, convertible bonds, or a claim for tax purposes. Despite the fact that the statement was not considered decisive in the actual case this seems to be a much more balanced and correct approach which one can only sympathize. Moreover, the Danish Tax Board found that the convertible instrument in question should be treated as one single instrument (integration approach).

Against the above analysis it can be concluded that the Danish domestic tax treatment of mandatory and reverse convertibles is characterized by a high degree of uncertainty. This uncertainty is even more prevalent in an international context.

6. Warrant loans

6.1. Comparative considerations

In countries following a bifurcation approach warrant loans seem to be treated according to the tax rules governing the underlying instruments in the form of a bond and a warrant/option. In *Swedish* law such instruments are known as ”teckningsoptioner med skuldbrev” or ”optionslån”, which have been directly governed by Swedish company law since 1975[587]. The Swedish tax treatment of warrant loans is divided into partly warrant (teckningsoption) partly bond (skuldbrev) and the purchase price is divided according to the ”restvärdemetod” or the ”C-metoden”, according to which the value of the bond is set at fair market value and where any remaining value is allocated to the warrant[588].

6.2 Federal US Tax Law

Warrant loans are commonly known in the US[589]. Frequently, issuers in the US market raise capital through the issuance of an investment unit, which typically consists of a debt instrument plus a warrant to acquire the issuer’s stock[590]. Investment units are defined in the IRC Sec. 1273(c) as a debt instrument and an option, security, or other property right. At least in terms of the US OID rules, the warrants are treated as a separate property right, and it is therefore necessary to allocate the overall purchase price between the two assets acquired[591]. Such an allocation is based on relatively fair market values and the value of the warrants is based on their value at the time of issuance, and not at the time of exercise[592]. When a warrant is exercised, no gain or loss is recognized to the holder of the warrant. The amount paid for the warrant simply becomes part of the basis for the stock acquired for the warrant. Moreover, the issuer does not receive an interest deduction or recognize a loss equal to the excess of the value of the stock over the sum of the amount received for the warrant and the amount received upon its exercise[593].

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[587] Cf. *Dahlberg*: Ränta eller kapitalvinst: Grundproblem i kapitalindkomstbeskattningen – särskilt vad gäller finansiella instrument i gränslandet mellan lånekapital och eget kapital, 2011, p. 533.
[588] Cf. 48 kap. 14 § IL, and *Dahlberg*: op.cit., p. 541 et seq.
[589] *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 1001.01 et seq. describes these types of instruments as debt issued together with property rights, where warrants and options are subsections to this overall category.
[590] See *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 10,002 et seq.
[591] Id.
[592] Id.
[593] See *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 10,004.

6.3 German Tax Law

Warrant loans and option loans (optionsanleihen) are commonly used in the German market and are treated largely similar to convertible bonds[594]. The tax treatment of the issuer of a warrant bond in Germany is identical to that in the case of issuance of a convertible bond[595].

In case of a corporate holder, the taxation of profits deriving from a warrant bond follows the accounting treatment. This means that the bond and warrant are treated as independent assets for tax purposes, i.e. a bifurcation approach. As a result warrant and option loans are treated in their components as a bond and as a warrant/option[596]. In specific circumstances the owner of ”optionsanleihen” can be regarded as a participant of a capital company[597].

As a consequence of this classification the warrant bond produces interest income which is taxable for the holder and deductible for the issuer[598]. Income and expenses have to be allocated over the lifetime of the bonds. The issuance of warrant loans and convertible bonds do not result in a realization of (taxable) capital gains or losses either at the level of the creditor or the German resident debtor company[599].

Convertible bonds and option loans may be classified as equity if they also include other equity characteristics[600].

6.4 Danish Tax Law[601]

Warrant and options loans are not commonly used in Danish law. Despite the similarities to convertible bonds case law and commentary is very limited.

In SKM 2006.60 LSR the Danish Tax Tribunal indirectly took a position on warrant loans as part of an incentive scheme for employees in the issuing company. More precisely the issue at hand was the establishment of the time of acquisition, which was found to be at the granting of the instruments to the employees. As a matter of principle the Danish Tax Tribunal made a remark of general importance. The Tax Tribunal stated that the granting of warrants in connection with the issuance of a bondloan should be treated as two separate arrangements. In this regard the Tax Tribunal emphasized that the two

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[594] See *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 185 et seq., *Laukkanen*: Taxation of Investment Derivatives, 2007, p. 328, *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 254 et seq., and *Haun*: Hybride Finanzierungsinstrumente im Deutschen und US-amerikanischen Steuerrecht, 1996, p. 203.
[595] See *Trapp* in DFI 1999, p. 325.
[596] See *Briesemeister*, id., p. 257.
[597] See *Briesemeister*, p. 262.
[598] See *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 189, *Helminen*: The Dividend Concept in International tax Law, 1999, p. 299.
[599] *Theisen* in Tax Treatment of Financial Instruments, 1996, p. 187.
[600] *Helminen*: The Dividend Concept in International tax Law, 1999, p. 299.
[601] See for a thorough analysis regarding Danish law *Bundgaard*: Warrantlån og optionslån i dansk og international skatteret, TfS 2012.118.

distinct financial instruments did not have an identical term and that the warrants could not be seen as directly being part of the issuance of the loan.

The leading case in Denmark is a Supreme Court decision dated 22th December 2011, cf. SKM 2012.2 H DSV A/S. A leading Danish listed company obtained external financing for the acquisition of another foreign company in 2000. The financing was obtained through issuance of shares, plain vanilla bank loans and through mezzanine capital. As a part in the financing agreement warrants were issued to one of the creditors as part of the conditions of the overall financing package. The warrants were transferrable to third parties and no specific payment was agreed for the warrants. The warrants should be exercised no later than 30 months after the repayment in full of the loan. Moreover, the issuer should pay a so-called back-end fee per share for a drop in the listed share price. All warrants were exercised in 2004 and 2005 at a favorable value. The costs in this regard, including the back end fee were computed as the difference between the listed price for the shares and exercise price. The costs were treated as deductible costs by the company. The Danish tax authorities did however, not recognize the deduction. The Supreme Court made the arguments clear in stating that the case was basically about the deductibility of costs according to KGL as a loss suffered in the context of loan repayment or as costs of obtaining a loan.

The Supreme Court did not consider the costs to be losses as a cost of obtaining a loan as precisely defined in KGL § 26(3) and the preparatory work to this provision. Moreover, the Supreme Court stated that KGL did not include the tax treatment of warrants under its scope. Warrants are covered by ABL with respect to the investor. It was stated that the loan and the warrants should be seen as two separate agreements where the tax treatment is handled by different sets of rules. The two agreements were considered to be connected in the sense that the issuance of the loan was closely connected to the granting of warrants. The Supreme Court stated that the value of the loan was not affected by the warrants. As a consequence the Court found that the loss should not be considered a capital loss regarding the loan falling under the scope of KGL. The same result was found to be the case regarding the back-end fee, which was treated together with the warrants.

This decision has resulted in a clarification of certain issues in the Danish tax treatment of warrant loans.

From an overall policy perspective it is a remarkable result that the issuing company is not allowed any deduction for a cost of financing. This result may not be in line with the neutrality objective regarding

similar financing alternatives. However, the outcome does not conflict with the tax treatment of convertible bonds and shares[602]. From this perspective the decision should hardly be critizised.

Notably, the Supreme Court applies a bifurcation approach to warrant loans in Danish law. The Supreme Court's reasoning in this regard is that the grant of the warrants is a condition for the advance of the loan and that the warrants concretely did not affect the value of the loan. On this basis is may be stated that the bifurcation approach should be applied when this requirement is fulfilled. If, on the other hand, the value of the loans was affected, the outcome might be different.

As a consequence of the decision the warrants were considered acquired at zero value. This should, in my view, however, not be a general guideline in terms of setting the value of granted warrants in warrant loan arrangements. Form a legal perspective the decision seems correct in concluding that the costs are not deductible.

7. Contingent Convertibles

7.1. Comparative considerations

The Contingent Convertible (CoCo) as a type Additional Tier 1 capital is analyzed from a tax law perspective in the Comparative Survey in DFI may/June 2011. Key features are described in the introduction to the comparative survey in DFI 2011, p. 96. The relevant tax questions examined are: Treatment of bonds prior to conversion as debt or equity, criteria for the characterization as equity, where treated as debt, the deductibility of interest paid on the bonds for corporate tax purposes and withholding tax imposed on interest paid, and finally the treatment of interest deferrals and the influence of an alternative coupon settlement as well as the tax consequences at conversion[603].

CoCos are still a novelty on the financial markets and no uniform treatment and classification exist. The United Kingdom would most likely classify CoCos as convertible securities and apply a bifurcation approach, whereby the product would be split into a loan and an embedded option (where the option can be exercised only for a fixed number of shares for a fixed amount of cash) or an embedded derivative (where it is not treated as an equity instrument)[604]. In Canada there would appear to be a good basis for deductibility of interest paid on CoCos by the issuer[605]. In the Netherlands it seems that uncertainty prevails and the relevant test is whether the debt effectively functions as equity[606]. CoCos are not

[602] Cf. Bill L 195, 1996-1997.
[603] The survey includes country practices in United States by *Hammer, Chen and Carman*, p. 97 et seq., in United Kingdom by *Stuttaford & James*, p. 107 et seq., in Canada by *Sinclair*, p. 108 et seq., in the Netherlands by *Specken*, p. 112 et seq., in Germany by *Krause*, p. 113 et seq., in France by *Jolly*, p. 115 et seq., in Italy by *Ragusa*, p. 118 et seq., in Switzerland by *Schmucki-Fricker*, p. 120 et seq., and in Luxembourg by *van Kuijk*, p. 122 et seq.
[604] See *Stuttaford & James* in DFI 2011, p. 107. The authors state that the treatment is likely to change as a result of IFRS 9.
[605] See *Sinclair* in DFI 2011, p. 108 et seq.
[606] See *Specken* in DFI 2011, p. 112.

familiar to the French market, but should be treated as debt for tax purposes[607]. The classification in Italian law is also highly uncertain[608]. Under Swiss law CoCos will usually be treated as debt for tax purposes based on the booking in the statutory accounts.

7.2 Federal US Tax law

CoCos' features are described by *Trier* et al, op. cit., p. 3 et seq. as bonds which cannot be converted by the holder unless a price in excess of the normal conversion price is achieved. Thus for example, a convertible bond with a CoCo-feature that has a conversion premium of 20 percent might be convertible only if a price equal to 120 percent of the conversion price is attained.

The US Internal Revenue Service has issued a public ruling (Rev. Rul. 2002-31) that describes under which conditions a contingent convertible debt instrument may be treated as debt for US tax purposes[609]. According to US commentary the CoCo is not sufficiently similar to the instrument considered in Rev. Ruling 2002-31 to be able to conclusively rely upon the ruling for a characterization as debt. Thus, the CoCo must be tested under the general rules for distinguishing debt and equity under US tax law[610]. US commentators conclude that[611]:

"…On balance, a few of the factors that the IRS and courts have used to determine whether an instrument is debt or equity support the view that the CoCos here are debt, but other factors support the view that the CoCos are equity. In particular, the conversion feature and the lack of an unconditional promise to pay a sum certain, the subordinated status of the instruments, and the lack of creditor rights upon conversion all weigh in favor of equity treatment. Further, if the term of the CoCos is perpetual, then that factor, combined with the others, would strongly weigh in favor of equity treatment. Assuming that the term is fixed in the range of 30 to 50 years, however, the ultimate conclusion the IRS or a court reaches will probably rest on the likelihood that the conversion will be triggered. This is because a CoCo's novel feature is that it has a mandatory conversion feature that, unlike conventional convertible debt, which is generally respected as debt for U.S. federal income tax purposes, does not guarantee that the conversion will give the holder stock having a value equal to or greater than the principal amount of the CoCo. This mandatory conversion feature, depending on the likelihood that it will be triggered, results in the lack of an unconditional promise

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[607] See *Jolly* in DFI 2011, p. 115.
[608] See *Ragusa* in DFI 2011, p. 118.
[609] *See Hammer, Chen & Carman in DFI 2011, p. 97 et seq. and Hammer & Chen:* Tax Implications of Contingent Convertible Securities. Host Country Response: UNITED STATES (draft), Tax Management International Forum Spring 2012, and *Kramer*: Financial Products. Taxation, Regulation and Design, Vol. 3. § 49.08.
[610] Id.
[611] *See Hammer, Chen & Carman in DFI 2011, p. 102 and Hammer & Chen:* Tax Implications of Contingent Convertible Securities. Host Country Response: UNITED STATES (draft), Tax Management International Forum Spring 2012.

to pay a sum certain, which is perhaps the most important factor supporting the classification of an instrument as debt….".

And finally:

"…Absent a ruling from the IRS, the treatment of CoCos cannot be determined with certainty, and equity treatment for tax purposes may become the opinion standard followed by most issuers. However, given the proclivity of the tax authorities to be supportive of the debt treatment of hybrid type instruments approved by banking authorities, the U.S. tax authorities could conclude that debt treatment is proper…".

7.3 German Tax Law

In German law the classification of CoCos depends on whether the issuer is a partnership or a corporation[612]. If the issuer is a partnership, a CoCo should qualify as debt as, from a civil law perspective, if it is structured in a debt format[613]. Prior to conversion, the CoCo does not entitle the holder to any rights a partner has[614]. With respect to corporations the situation is less clear in German law and is a grey area. If CoCos satisfy the GAAP criteria for equity treatment, it would qualify as equity[615]. However, there is no obvious result since equity classification is supported by perpetuity, contingency of coupons and exclusion of insolvency whereas debt classification is supported by the debt format[616]. *Krause* finds that the intended burden on the issuers is to pay fixed income rather that sharing profits and losses. No unique view has been formed in the industry in Germany regarding the classification of CoCos issued by corporates. In light of the sharp borderline between equity or debt, and nothing in between, even a minimal modification of the term sheet or a minimal ramification might result in inverting the classification[617].

7.4 Danish Tax Law

Contingent Convertible bonds have not been dealt with in Danish legislation or Danish case law. Accordingly, the classification of such instruments should be carried out in accordance with the traditional principles of tax classification. Consequently, the classification depends on the debt-equity features included in the actual instruments. Generally speaking, in my opinion the most likely classification of CoCos follows the above on mandatory and reverse convertibles. In one recent case from the Danish Tax Board in SKM 2014.711 SR CoCos were dealt with for the first time. The Tax Board was asked to confirm that a specific type of security with a contingent feature would be classified as a claim for the potential investors which was subject to taxation according to KGL. The security in question was

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612 See *Krause* in DFI 2011, p. 113.
613 See *Krause* id.
614 See *Krause* Id.
615 See *Krause* id.
616 Id.
617 *Krause*, op.cit., p. 114.

issued at par value with a stated interest. Moreover, the creditor could not demand conversion. Repayment would occur at a certain date if conversion had not taken place prior to this date. The Tax Board did not consider the security to be a convertible bond for Danish tax purposes since the creditor could not demand conversion. Moreover, the Tax Board did not consider the security to be a structured bond according to KGL § 29(3). Instead, the Tax Board found that the security should be classified as a traditional claim subject to taxation according to KGL. The Tax Board did not consider it to be of any significance that the claim could potentially be repaid in shares rather than in cash.

8. EU Corporate Tax Directives

8.1. Optional Convertible Bonds

Two EU corporate tax directives come into play concerning the tax treatment of convertibles and the remuneration thereon: The Parent/Subsidiary Directive and the Interest/Royalty Directive.

The Parent/Subsidiary Directive applies to equity financing while the Interest/Royalty Directive applies to debt financing.

The Interest/Royalty Directive is more informative than the Parent/Subsidiary Directive in terms of defining the payments included under the scope of the Directive. The notion of interest is defined directly in Article 2, par. 1(a) of the Directive as:

(a) the term "interest" means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest.

The wording refers to debt claims of any kind. Based on this, any debt claim that is a debt claim for private law purposes falls under the scope of the Interest/Royalty Directive. At first glance, the notion of interest of the Interest/Royalty Directive is particularly wide and also includes yield from certain hybrid financial instruments[618]. However, article 2 should be read in conjunction with article 4 of the Directive in order to assess the actual scope of the interest definition[619]. In Article 4 of the Interest/Royalty Directive, the source State is granted the right not to ensure the benefits of the Directive in cases where some common types of hybrid financial instruments are used.

[618] See *Distaso & Russo* in ET 2004, p. 149.
[619] *Id*.

The third exclusion from the notion of interest is *interest payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits*; cf. article 4, para. 1(c).

The wording of this provision is ambiguous. According to *Distaso & Russo*, a literal interpretation of the formulation in the Directive seems to clearly include those interest-bearing loans that provide the possibility for the creditor to convert his entitlement to the interest into the right to a percentage of the profits of the borrower[620]. However, the reference to the "right to participate in the debtor's profits" rather than to the "debtor's equity" does not clearly and automatically include those financial instruments granting the right to convert the loan (and in certain cases the interest income accrued) into the share capital of the borrower (i.e. traditional convertible loans/bonds). The question is whether the reference to the right to interest is simply another term for the claim in general and that the reference to the right to participate in the debtor's profits simply is another way to describe participation in the debtor's equity. It has been argued on the basis of a literal interpretation of the provision, according, that this excludes convertible bonds and warrant bonds from the scope of the IRD[621].

Accordingly, such instruments and the yield thereon may fall outside the scope of the Interest/Royalty Directive. The enumeration of excluded financial instruments should be considered exhaustive in contrast to previous drafts of the Directive[622]. An e contrario interpretation should lead to the conclusion that in the absence of this specific provision in article 4, par. 1(d) such instruments would fall under the scope of the interest definition.

If the Member States in question do not exercise the right to exclude convertible debt instruments from the benefits of the Directive, this means that such instruments may in fact benefit from the Directive.

In such situations it becomes relevant whether other features such as interest-deferral mechanisms are in line with the interest definition in Art. 2.

The effect of article 4, par. 1(a) on national thin cap provisions that do not result in a reclassification is yet uncertain[623]. In line with the analysis presented above, it is commonly agreed in commentaries that such payments treated as distributions of profit in the source state should fall under the scope of the Parent/Subsidiary Directive instead[624]. This was also explicitly stated in COM (1998) 67 final regarding

[620] See *Distaso & Russo*, id., p. 150.
[621] See *Eberhartinger & Six*, id. p. 24, and *Distaso & Russo,* id., p. 150.
[622] See *Weber* in EC Tax Review 2000, p. 25.
[623] See *Gusmeroli* in European Taxation 2005, p. 39 et seq. (p. 44).
[624] See *Eberhartinger & Six*: National Tax Policy, The Directives and Hybrid Finance, 2006, p. 23. and *Distaso & Russo*, id. p. 150.

the previous draft to the Directive. A similar result is not presupposed as regards the interest payments mentioned under Art. 4(b)-(d). However, if such payments (including interest payment on convertibles) are in fact reclassified as "distributed profits", the same interpretation ought to apply to such payments as well. Accordingly, the Parent/Subsidiary Directive may be said to take precedence over the Interest/Royalty Directive[625]. It has been argued in tax literature that the Parent/Subsidiary Directive includes income from hybrid debt, which, by nature, is actually equity and therefore taxed as a dividend in the Member States[626]. Based on this, it has moreover been argued that the Parent/Subsidiary Directive is applicable to income from convertible debt if Member States choose to tax interest on convertible debt as a dividend[627]. Finally, it has been argued that the Parent/Subsidiary Directive is applicable to convertible loans from a corporation to its shareholder if the loan itself under domestic law is considered constructive dividend and constitutes a distribution of profits from a subsidiary to the parent company, made by virtue of the association between the companies[628].

Payments on convertible debt instruments falling outside the scope of the Interest/Royalty Directive do not automatically fall under the scope of the Parent/Subsidiary Directive. Accordingly, there is no guarantee that payments on convertible debt instruments that have been denied the rights under the Interest/Royalty Directive are granted the rights under the Parent/Subsidiary Directive instead.

7.2 Mandatory convertibles

Mandatory convertibles and reverse convertibles have not been addressed directly in any existing EU sources of tax law. The above presented interpretation leaving convertible instruments outside the scope of the Interest/Royalty Directive may also apply to mandatory and reverse convertibles. This question is still uncertain. Accordingly, such instruments and the yield thereon may fall outside the scope of the Interest/Royalty Directive.

If the Member States in question do not exercise the right to exclude convertible debt instruments from the benefits of the Directive, this means that such instruments may in fact benefit from the Directive.

In such situations it becomes relevant whether other features such as interest-deferral mechanisms are in line with the interest definition in Art. 2.

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625 *Eberhartinger & Six*, id., moreover raise the question of what will happen if payments that qualify as profit distributions under the tax law of the source State fall under the scope of the Parent/Subsidiary Directive and if the source State does not execute the option in Art. 4, par. 1(a) of the Interest/Royalty Directive and if these payments fall under the scope of both directives.

626 Cf. *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 301 and The International Tax Law Concept of Dividend, 2010, p. 193.

627 Id.

628 Id.

Payments on mandatory and reverse convertible instruments falling outside the scope of the Interest/Royalty Directive do not automatically fall under the scope of the Parent/Subsidiary Directive. Accordingly, there is no guarantee that payments on convertible debt instrument that have been denied the rights under the Interest/Royalty Directive are granted the rights under the Parent/Subsidiary Directive instead.

8.3 Contingent Convertibles

Due to the common feature of convertibility between optional, mandatory, reverse and contingent convertible instruments the analysis in terms of the applicability of the EU company tax directive is considered identical. Accordingly, reference is made to the above section 8.2.

8.4 Warrant loans

It is not commonly seen that warrant loans are treated as equity. Should this occur, it raises the question whether withholding tax can be triggered and whether the Parent-/subsidiary Directive applies. This question is yet unclarified, but an application of the PSD requires that the source state will classify the yield as a dividend and that the CJEU will carry out a teleological interpretation[629].

A bifurcation approach is likely to apply whereby the debt element of the warrant loans should be treated according to the Interest/Royalty Directive.

The treatment of yield on warrant loans seems to be identical to the treatment of the yield on convertible bonds. Accordingly, reference is made to the above section on the treatment of yield on convertible bonds according to EU company tax directives.

9. Double Tax Treaties

9.1 Optional convertibles

In general, the remuneration on hybrid financial instruments may classify as business income under article 7, dividend payments under article 10 as interest payment under article 11, capital gains under article 13 or as other income under article 21 in double tax treaties agreed on the basis of the OECD Model Tax Treaty. For the sake of simplicity, only the dividend-provision and the interest-provision are analysed in the following with respect to convertible debt instruments. The demarcation is of great importance since the taxing right under the treaties differs depending on the type of income.

Convertible bonds and the tax treaty treatment of such instruments are not directly mentioned in the wording of the OECD model. With respect to convertible bonds it is explicitly stated in par. 24 to article 10, that interest on convertible debentures is not a dividend. Moreover, it is stated in para. 19 to article

[629] Cf. *Bundgaard*: Classification and Treatment of Hybrid Financial instruments and Income Derived Therefrom under EU Corporate Tax Directives, European Taxation, 2010, p. 442 et seq. and p. 490 et seq.

11 of the OECD Model, that interest on convertible bonds should not be considered as a dividend until such time as the bonds are actually converted into shares. However, a reservation is made in para. 19 that such interest should be considered as a dividend if the loan effectively shares the risks run by the debtor company.

Based on this, it is generally assumed that interest on convertible instruments qualifies as interest according to the OECD Model because a convertible loan is not a corporate right[630]. A conversion right does not constitute corporate rights.

The above also indicates that that dividend classification may occur on certain convertible instruments. It remains uncertain, exactly which type of convertible instruments could in fact be sufficiently taking part in the entrepreneurial risks of the issuing company to be considered a dividend generating right. It appears that dividend treatment will only occur if other equity characteristics are integrated into the convertible bond since the conversion rights do not on a stand-alone basis lead to a dividend classification. *Helminen* states that a convertible loan qualifies as a dividend-generating corporate right only after the actual conversion or if the investor, in addition to possessing the conversion right, also participates in the profits, liquidation proceeds and losses of the corporation[631].

Another question is that of the tax treatment of income realized through the conversion from debt into equity. Basically, the claim does no longer exist after the conversion. Accordingly, the question is whether the income can at all be considered interest income according to the tax treaties[632]. The solution seems to arise from the Commentary to Article 13 of the OECD model, where para. 31 states that:

"*…The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to limited tax in the State of source of the interest in accordance with Article 11…*"[633].

9.2 Mandatory convertibles

The OECD Model and its commentaries do not deal with the classification of mandatory convertibles or reverse convertibles. If the conversion of a debt instrument is mandatory the conversion

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630 See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 193, *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 145 ("Erst mit dem Zeitpunkt der Ausübung des Umtauschrechts trägt er das unternehmerische Risiko"), *Fehér* in Burgstaller & Haslinger (eds.): Conflicts of Qualification in Tax Treaty Law, 2007, p. 247, *Schuch* in *Bertl et al* (eds.): Eigenkapital 2004, p. 231.
631 See *Helminen*, Id.
632 See *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht, 1991, p. 146 and *Schuch* in *Bertl et al* (eds.): Eigenkapital 2004, p. 232.
633 See also para. 20 to article 11 of the OECD Model Tax Treaty.

right/obligation may constitute the kind of risk required of dividend-generating corporate rights[634]. *Schuch* takes the claim and interest payment further by stating:

"…Auch Wandelsschuldverschreibungen – egal, ob mit Wandlungsrecht des Investors oder des Emittenten oder einer zwingenden Wandlung (mandatory convertible) – gehören nicht zu den Dividendenwerten iSd Art 10 OECD-MA…"[635].

Fehér points to the form-based approach of article 11, where debt claims of every kind shines through the entire definition of interest[636]. The author moreover points towards difficulties treating mandatory convertible bonds as instruments producing interest. The following is said:

"…The holder does not seem to have a real claim in respect of its contribution. Of course, this would depend on the details of the arrangement (guarantees, etc.), but a drop in the share price were to lead to a drop in the redeemable amount of the contribution, then we would hardly speak of a genuine claim in respect of the principal, and thus the yield would not qualify as interest for treaty purposes…"[637].

In a comprehensive analysis of the classification of reverse convertibles, *Rotondaro* has analysed the notion of "interest" as applied in article 11(3) of the OECD Model Tax Convention[638]. *Rotondaro* argues that the existence of an *absolute and unconditional right to redemption* is to be regarded as the basic feature of the debt claims giving rise to interest under article 11 of the OECD Model Convention[639]. The author states that, irrespective of the fact that uncertainty is present in an instrument regarding the yield, this does not exclude interest classification under the tax treaties; the opposite conclusion is to be made regarding uncertainty as concerns the redemption of the principal[640]. Following this view there can only be interest under article 11 when the lender has a certain and unconditional right to the repayment of the face value of the credit. With respect to reverse convertibles the author concludes that proceeds from such instruments cannot be regarded as interest for the purpose of the OECD model tax treaty and of the treaties concluded in accordance thereto[641]. Instead it is considered more suitable to allow reverse convertible yields to fall within the scope of application of article 13 regarding capital gains as the requirements under this provision appear to be looser and less demanding.

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634 See *Helminen*, Id.
635 *Schuch* in *Bertl et al* (eds.): Eigenkapital 2004, p. 231.
636 *Fehér* in Burgstaller & Haslinger (eds.): Conflicts of Qualification in tax Treaty Law, 2007, p. 247.
637 Id., p. 248.
638 See DFI 2000, p. 258 et seq.
639 Id., p. 264.
640 Id., p. 265.
641 Id., p. 268.

Based on the above no firm conclusion can be made with respect to the tax treaty classification of mandatory convertible debt instruments.

9.3 Contingent Convertibles

Due to the common feature of convertibility between optional, mandatory, reverse and contingent convertible instruments the analysis in terms of the applicability of double tax treaties seems parallel. Accordingly, reference is made to the above section 9.1. and 9.2. Accordingly, no firm conclusion can be made with respect to the tax treaty classification of CoCos.

9.4 Warrant loans

For tax treaty purposes emphasis should be paid to the fact that warrant loans and option loans contain a claim apart from the warrant or option which is also contained in the instrument. This is expressed as follows by *Lang*:

"…Die Einräumung eines Bezugsrechts änders aber nichts Daran, dass die Anleihe auch einen Rückzahlun gsanspruchs hinsichtlich des gesamten oder wesentlicher Teile des hingegebenen Kapitals verkörpert. Es liegt somit eine "Forderung" im abkommensrechtliche Sinn vor. Sowohl die Gewährung von Zinsen als auch die Gewährung eines Bezugsrechts auf Aktie stellen daher Einkünfte aus Forderungen dar…"[642].

In those instances where the warrant can be separated from the loan or possibly traded separately this should constitute a separate asset. If the warrant is not exercised, but is rather transferred this should be viewed as a transfer of property in the sense of article 13 of the OECD Model Convention, unless the warrant can be allocated to a permanent establishment according to article 7(1) of the OECD Model Convention. The exercise of the warrants results in the existence of shares, which are considered "corporate rights" in accordance with article 10 of the OECD Model Tax Convention. Any further income on the shares should as a consequence be considered dividends for tax treaty purposes[643].

[642] See *Lang*: Hybride Finanzierungen im Internationalen Steuerrecht – Rechtsgrundlagen der Doppelbesteuerungsabkommen zur Beurteilung von Mischformen zwishen Eigen- und Fremdkapital, 1991, p. 147 and supportive *Schuch* in Bertl et al (eds.): Eigenkapital, 2004, p. 232.
[643] Cf. *Lang*: op.cit., p. 147.