Corporate Taxation, Group Debt Funding and Base Erosion

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Series Editors

Introduction

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Corporate Taxation, Group Debt Funding and Base Erosion

New Perspectives on the EU Anti-Tax Avoidance Directive

Edited by

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CHAPTER 2

The Preference of Debt over Equity for Tax Purposes

Jakob Bundgaard & Michael Tell

§2.01 SCOPE AND OUTLINE

The purpose of this introductory chapter is to shed light on the overall distinction between debt and equity from the perspective of corporate tax law.[1] A general description is provided of the difference between debt and equity, which is followed by a presentation of the tax implications arising from the use of debt and equity. Finally, the chapter concludes with a brief overview of the tax policy discussions which have evolved around the topic.

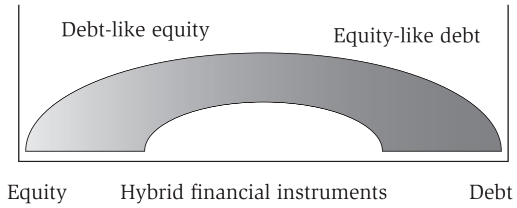
§2.02 INTRODUCTION

Essentially, companies can be financed by issuing debt or share capital (balance sheet) or by earnings (profits and losses). In addition, several other financing techniques are available, including leasing, securitization[2] and debt workouts. "Debt" and "equity" are labels for the two ends of a spectrum, between which lies an infinite number of instruments, each differing from its closest neighbors in barely perceptible ways.[3] These include hybrid financial instruments, combining debt as well as equity features.

1. The chapter is largely based on the monograph *Bundgaard*: Hybrid Financial Instruments, Kluwer, 2017.
2. *See Humphreys & Merali*: Tax Treatment of Structured Finance Transactions in PLI Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings, 2006, pp. 831 et seq.
3. For this description *see Bittker & Eustice*: Federal Taxation of Corporations and Shareholders, 2002, pp. 4-12.

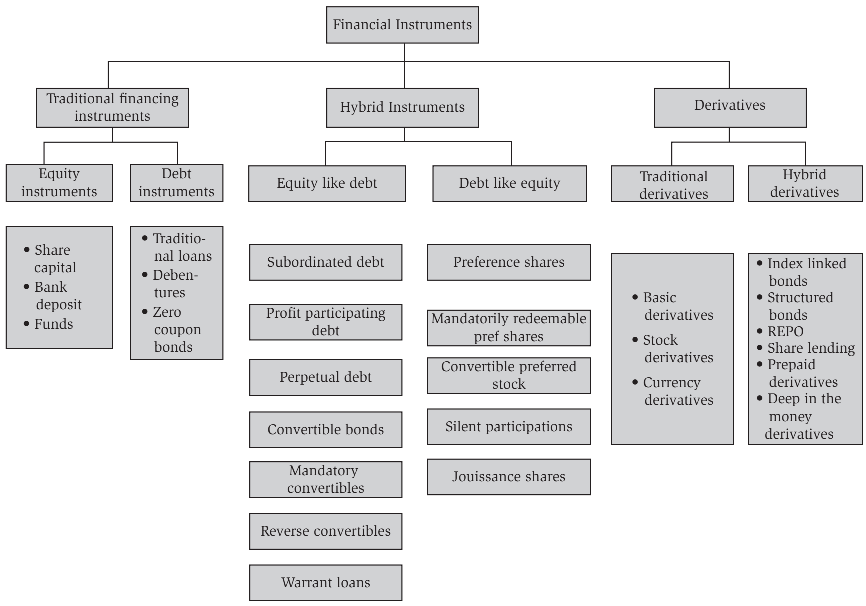
The sources of corporate financing may be exemplified by a continuum, as illustrated in Figure 2.1.

Figure 2.1 The Debt-Equity Continuum



Within the world of financing, a vast array of different types of instruments exist, and more and more variations are being developed. A commonly adopted method of providing an overview is through the use of a so-called classification tree, as presented in Figure 2.2.

Figure 2.2 Classification Tree



Several legal and economic differences between debt and equity instruments can be pointed out.[4] First, the legal differences are the following (Table 2.1).[5]

Table 2.1 Legal Differences Between Debt and Equity

Equity	*Debt*
The owner of shares is normally entitled to a proportion of the profits of the company.	The provider of loan capital is normally entitled to a periodical amount of fixed interest on the amount lent, regardless of the profit, if any, made by the company.
The owner is not normally entitled to recover the original investment except on the dissolution of the company.	The lender is normally entitled to recover the investment after a certain period.
The risks that the owner undertakes are normally limited to the amount of equity capital that the owner has subscribed or has undertaken to subscribe.	Like a shareowner, the lender risks losing the entire investment.
However, the owner would usually be able to sell the shares and thus recover the current value of the investment, which might be more or less than the amount originally invested.	The lender may in some circumstances be able to make an earlier sale of the rights to another person, at which point the lender may recover either more or less than the original investment, although the factors affecting the sale value of a bond may well be different from those affecting the value of a share.

Second, the *economic difference* is said to be that a lender (loan creditor) will look to a periodic fixed remuneration for the use of their loan capital, and to the return of the loan capital itself at the end of the loan period, while a shareholder must wait for an (additional) upside to manifest itself before the directors of the company decide that profits can be spared for distribution rather than reinvestment.[6] Debt is traditionally described as providing an investor with cash flow rights that are certain as far as the amount invested is concerned. In contrast, dividends and ordinary shares are examples where there are no rights to a cash flow as a result of the transaction.[7] There are financial risks for investors in both debt and equity, but the financial risk for equity holders is usually considered higher,[8] but also entails an infinite economic upside. As such, distinction between equity and debt is made by reference to the degree of

4. Emphasized by the *OECD* Fiscal Committee on Thin Capitalisation, Issues in International Taxation, 1987, pp. 8 et seq.
5. *See* for example the *OECD* report: Thin Capitalisation adopted by the OECD Council on November 26, 1986, legal and economic differences are pointed out in paras. 3-5. *See also Ferran*: Company Law and Corporate Finance, 1999, pp. 47 et seq., characterizing equity by the following factors: dividends, capital growth (capital gains and risk) and voting rights. *See*, moreover, *Mattsson*: Aktiebolagens finansieringsformer, 1977, pp. 9 et seq.
6. *See OECD* Fiscal Committee on Thin Capitalisation, Issues in International Taxation, 1987, pp. 8 et seq. *See also Coyle*: Hybrid Financial Instruments, 2002, pp. 2 et seq. for an overview of the economic differences between debt and equity.
7. *Id.*
8. *See Coyle*: Hybrid Financial Instruments, 2002, pp. 2 et seq. for an overview of the economic differences between debt and equity, p. 4 and *McCormick & Creamer (eds.)*: Hybrid Corporate Securities: International Legal Aspects, 1987, pp. 2-3.

certainty attached to the direction, timing and amount of cash flows.[9] In essence, debt is a resource that does not belong to the company (loan capital), while equity is part of the company's own resources.[10] Consequently, a company which is financed primarily by equity may operate in a very different way to a company mainly financed by debt.

Furthermore, in terms of corporate governance, the holders of equity are entitled to make decisions on the part of the company, while holders of debt are relegated to the sidelines. Traditional debt holders can take no part in the management of the borrowing entity, and the borrowing entity owes them no explanation for their actions.[11]

As an overview of the core elements of debt and equity, the following can be pointed out:

- Equity has no maturity, no ongoing payments that could trigger a default if unpaid, and loss absorption benefiting all creditors.[12] Debt, in contrast, usually has fixed payments and a stated maturity.
- Nonpayment of principal or interest constitutes default. Whereas shareholders are the last class of security holders to receive distributions in liquidation, debt holders, by contrast, have a right to receive payments before equity holders.[13] Equity holders may be entitled to a dividend, subject to declaration by the issuer, and equity instruments may entitle the holder to some voting rights. Dividend payments may be cumulative or noncumulative.[14]

The legal and economic differences between debt and equity also give rise to different tax treatments of debt and equity as described in the section below.

§2.03 TAX RAMIFICATIONS OF THE DEBT-EQUITY DISTINCTION

[A] General Overview

The distinction between debt and equity is considered to be one of the fundamental and yet unsolved issues of international tax law. In most jurisdictions, the distinction remains relevant to ensure the correct *classification* and the corresponding *tax treatment* of the yield from debt or equity.

9. *See OECD*: Innovative Financial Transactions: Tax Policy Implications, 2001, pp. 21-22.
10. *See Brown* in Cahiers, vol. 97b, The Debt-Equity Conundrum, 2012, p. 40.
11. *See Poindexter* in Berkeley Business Law Review, 2005, p. 253, explaining that the basis for the distinction evolves from contract theory: "While the underlying duty of the firm to its equity holders is fiduciary, the duty to its creditors is contractual. Thus, in the authors mind to determine whether an investment is debt or equity, we should ask whether the duty of the firm to investors is fiduciary or contractual." As stated in *McCormick & Creamer (eds.)*, in Berkeley Business Law Review, 2005, p. 2, these distinctions may have little economic significance in relation to HFIs, but they are of fundamental importance in determining the legal nature of the HFI.
12. *See Eiger, Green, Humphreys and Jennings & Mares*: Hybrid Securities: An Overview, Practical Law, Multi-Jurisdictional Guide 2015/16, Capital Markets, pp. 1 et seq.
13. *Id.*, p. 2.
14. *Id.*

In simple terms, the core tax issue of corporate finance is the difference in the tax treatment of the remuneration on debt and equity. If tax laws were neutral, it would be irrelevant from a taxation perspective whether corporations were financed through debt or equity, whereas the lack of neutrality makes it crucial to be able to distinguish between equity/dividends and debt/interest.[15] As a general rule, the tax treatment of equity financing and debt financing follows the same basic principles around the world[16] but entails a preference of debt over equity as explained in further detail below. The debt bias is well documented.[17]

The debt-equity conundrum has been dealt with in various ways in different jurisdictions. A global trend has emerged over a longer period of time which has gained speed most recently with the aim of neutralizing the treatment of debt and equity.[18]

Relevant measures include means of reducing the appeal for debt financing by restricting interest deductibility or reclassifying debt into equity.[19] As of 2021, interest limitation rules are mandatory in all European Union (EU) Member States and recommended by the Organisation for Economic Co-operation and Development (OECD)/G20 in the Base Erosion and Profit Shifting Project (BEPS).[20]

Alternative approaches to the above interest restrictions include allowance for equity or deductible dividends. Such approaches stimulate equity investments positively rather than (negatively) restricting debt financing. In recent years, several countries have followed this approach and countries such as Belgium, Brazil, Liechtenstein and Italy have all introduced rules which allow companies a deduction for notional interest on equity. Other countries have considered introducing similar regimes, and even the EU commission included an Allowance for the Cost of Equity (ACE) system in its proposals for a Common (Consolidated) Corporate Tax Base.

15. *See Helminen* in Kluwer Law International: The Dividend Concept in International Tax Law: Dividend Payments Between Corporate Entities, 1999, p. 12.
16. *See Piltz* in Cahiers, vol. LXXXIa, Permanent Establishments of Banks, Insurance Companies and Other Financial Institutions, 1996, pp. 87 et seq.; *OECD*, Thin Capitalisation, 1986, paras. 7 et seq., *Burmeister*: Unternehmensfinanzierung im Internationalen Steuerrecht, 2003, pp. 36 et seq.
17. *See also* the Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 5, which stated that a debt bias is found in most tax systems in the EU Member States.
18. *See*, for a recent analysis, for example *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011.
19. *Id.* and *Blessing* in Bulletin 2012, pp. 209 et seq. *See also Schön* in Bulletin 2012, pp. 490 et seq.
20. *See* Council Directive (EU) 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market and OECD/G20 Base Erosion and Profit Shifting Project on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 (Final Report dated October 2015 and Updated Report dated December 2016).

Despite the efforts to reduce the preference of debt over equity, as shown in this chapter, there still seems to be a preference of debt over equity for tax purposes, as it appears that more fundamental tax reforms are needed to overcome the debt bias.[21]

[B] Tax Framework Regarding Debt and Equity

The distinction between debt and equity has been established in the context of civil law, in particular contract law, corporate law and insolvency law.[22] Debt and equity serve as categories for particular combinations of financial risk and rewards, voting and control rights under a contract providing funds for a business as stated above.[23] From this starting point, the distinction between debt and equity has found its way into domestic tax law, while no specific international tax law regime exists regarding corporate financing.[24]

Clearly, a distinction between debt and equity is relevant in most countries, while in reality, the debt versus equity distinction is often mostly concerned with the interest versus dividend distinction rather than the actual debt versus equity distinction in itself, as the actual discrimination or preference for tax purposes is caused by:

- interest being deductible while dividends generally are not;[25]
- interest is taxable while some dividends often obtain a more favorable tax treatment;
- interest withholding tax and dividend withholding tax rates often differ, with interest generally being subject to lower rates or exemption;
- interest may accrue for tax purposes, but dividends are generally taxed on distribution.

Below the principles governing the taxation of cash flows from debt and equity instruments are described in general terms. The purpose of this general description is to illustrate the different tax treatment of remuneration from debt and equity.

[1] Tax Treatment of an Equity Issuer

Generally, corporate earnings from equity are subject to corporation tax in the country of residence of the issuing company. As a main rule, remuneration on equity (dividends) is nondeductible in the calculation of taxable profits.[26] As such, dividends are

21. *See also* Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, p. 9.
22. *See*, for example, *Schön* et al. in Competition and Tax Law Research Paper Series No. 09-09, 2009: Debt and Equity: What's the Difference? A Comparative View, Max Planck Institute for Intellectual Property, p. 2.
23. *Id.*
24. *See also Brown* in Cahiers, vol. 97b, The Debt-Equity Conundrum, 2012, p. 32.
25. *Id.*, p. 21.
26. *See*, for example, *Brown* in Cahiers, vol. 97b: The Debt-Equity Conundrum, 2012, p. 21.

paid out of taxed earnings. Exceptions to this rule do, however, exist in certain jurisdictions.[27]

[2] Tax Treatment of an Equity Investor

In the shareholder's country of residence, dividends are in principle taxable, possibly with a credit for the withholding tax and/or corporate income tax (CIT) levied at the level of the paying corporation. Presupposing the existence of an international affiliation privilege or participation exemption, the dividends are tax-exempt if the requirements are fulfilled.

In the country of source of the dividend, the shareholder may, in addition, be subject to a withholding tax on the shareholder's account, which is, however, reduced or eliminated in many instances as a result of double tax treaties or the EU Parent-/Subsidiary Directive (PSD).[28]

The state of residence of the dividend recipient has the right to tax according to Article 10(1) of the OECD Model Convention, while such dividends may also be taxed in the source state of the paying company, according to Article 10(2). The latter taxing right is limited under the OECD Model Convention, whereby the tax so charged shall not exceed 5% if paid to parent companies owning more than 25% of the capital of the company paying the dividends or 15% in all other cases. Double taxation arising from the imposition of withholding tax in the source state on a dividend received may be reduced by the application of the credit method under Article 23A(2) or Article 23B of the OECD Model Convention.

Dividends paid between companies in EU Member States are, in principle, covered by the PSD. The PSD requires double taxation to be avoided by either exempting the dividends or granting a tax credit equivalent to the tax already paid on the distributed profits. Dividends not covered by the PSD may be subject to (temporary or permanent) double taxation since no obligation to abolish such double taxation exists according to EU law. The PSD applies to distributions of profits between associated companies from different EU Member States. The companies involved must be subject to CIT in their respective Member State(s).[29] Both the payer and the recipient must be organized in a legal form listed in the annex to the directive. The profit

27. An example of an exception can be found, for example, in the Brazilian JCP-regime, which allows for deductible dividend distributions. *See* further details on ACE regimes in Working Paper No. 72 2018 from the European Commission written by *Nicola Branzoli and Antonella Caiumi:* How Effective Is an Incremental ACE in Addressing the Debt Bias? Evidence from Corporate Tax Returns, dated June 27, 2018.
28. *See also Burmeister*: Unternehmensfinanzierung im Internationalen Steuerrecht, 2003, pp. 36 et seq.
29. It should be noted that the ECJ has stated in the *Beneficial owner* cases (joined ECJ cases on dividends (PSD) C-116/16 and C-117/16 and the joined cases on interests (IRD) C-115/16, C-118/16, C-119/16, C-299/16) that there is, in EU law, a general legal principle that EU law, including the PSD, cannot be relied on for abusive or fraudulent ends and that a Member State *must* refuse to grant the benefit of the provisions of EU law, including the PSD, where they are relied upon in the aim of benefiting from an advantage in EU law, even if the conditions for benefiting from that advantage are fulfilled only formally, and despite the absence of provisions of national law providing for such a refusal.

distributions must be made to associated companies with a direct holding of 10% in the capital of the companies paying the dividends.[30]

[3] Tax Treatment of a Debt Issuer

Remuneration of debt (interest) is generally considered a deductible (business) expense in the calculation of taxable profits in the country of residence of the debtor/issuer.[31] As such interests are effectively free of CIT, whereas the creditor/lender in both the national and international contexts is the only person likely to suffer tax on interest payments.[32]

However, domestic restrictions on interest deductibility may impose limitations on the deductibility of the issuer.[33] Historically, rules on thin capitalization with a focus on solvency have been the predominant rules on limitations on the deductibility of interest,[34] while more general interest limitation rules based on the earnings of the issuer seem to be the new way forward, sometimes supported by more targeted rules such as rules on thin capitalization.[35]

All EU Member States are, as a minimum, obliged to transpose the earning-based limitation rule in the Anti-Tax Avoidance Directive (ATAD) Article 4, which is an implementation of OECD BEPS Action 4 approach. Other domestic and diverse restrictions targeting specific situations may also apply.[36] As such, exceeding borrowing costs (net financing cost) are not deductible if they exceed 30% of the company's or the group's earnings before interest, tax, depreciation and amortization (EBITDA), which is also the recommended approach in OECD BEPS Action 4. Even stricter general or targeted local interest limitation rules may also apply. In most non-EU Member States, more classic thin capitalization rules and local specific anti-tax avoidance rules still seem to be more predominant than the recommended approach in OECD BEPS Action 4.[37]

See also the ECJ's answers to question 5 in paras. 143-156 in C-118/16 on the application of the PSD on a Luxembourgish "Société en Commandite par Actions" (SCA) also classified as a "Société d'Investissement en Capital à Risqué" (SICAR).

30. *See also* paras. 70, 72 and 76 in the joined ECJ cases C-116/16 and C-117/16.
31. *See OECD*: Thin Capitalisation, 1986, para. 8, *Piltz* in Cahiers, vol. LXXXIa, Permanent Establishments of Banks, Insurance Companies and Other Financial Institutions, 1996, p. 92 and *Burmeister*: Unternehmensfinanzierung im Internationalen Steuerrecht, 2003, pp. 36 et seq.
32. *See OECD*: Thin Capitalisation, 1986, para. 8 and *Piltz* in Cahiers, vol. LXXXIa, Permanent Establishments of Banks, Insurance Companies and Other Financial Institutions, 1996, p. 92.
33. *See*, for example, *Brown* in Cahiers, vol. 97b, The Debt-Equity Conundrum, 2012, pp. 35 et seq.
34. *See Hinny* in Cahiers, vol. 93b: New Tendencies in Tax Treatment of Cross-Border Interest of Corporations, 2008, p. 23.
35. *See*, more in relation to the EU Member States, the Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 6.
36. *Id.*
37. Countries such as Australia, Brazil, Canada, China, Japan, New Zealand and South Africa still apply more traditionally based thin capitalization rules, while the US has recently adopted the earning-based approach as recommended in OECD BEPS Action 4.

[4] Tax Treatment of a Debt Investor

Generally speaking, interests received are as a main rule taxable in the hands of the investor/lender according to the domestic legislation of the country of residence.[38] However, this conclusion does not always include companies resident in tax havens which are either not subject to CIT at all or subject to very limited taxation.

The lender is usually liable to tax on the interest received but may claim credit for the withholding tax levied by the source state. Interest is not usually subject to withholding tax or at least to a withholding tax that is lower than a withholding tax on dividends. Withholding taxes on interest are often reduced or eliminated in the source state according to tax treaties or the Interest-/Royalty directive (IRD).

According to Article 11 of the OECD Model Convention, the right to tax interest income is allocated to the recipient's state of residence. However, according to Article 11, paragraph 2 of the OECD Model Convention, the interest income may also be taxed in the source state, but limited to 10% of the gross amount of the interest. According to tax treaties, double taxation arising from the imposition of withholding tax in the source state on a dividend received may be reduced by the application of the credit method as stated in Article 23A, paragraph 2 or Article 23B of the OECD Model.

Interest payments between associated companies within the EU may avoid withholding tax (but not income tax) according to the IRD. In Article 1, paragraph 1 IRD, it is stated that interest payments arising in a Member State shall be relieved from any form of tax in the source state on condition that the beneficial owner of the interest is a company or a permanent resident in another Member State belonging to a company in a Member State. Under the IRD, it is required that both the borrowing company and the lending company fall under the definition of a "company of a Member State," that is mentioned in the annex, a taxable entity resident in a Member State. Another important requirement is the association between the companies as defined in Article 3, paragraph 1(b). A company is considered to be associated with another company if it: (i) directly owns at least 25% of the capital of the other company, (ii) if the other company directly owns at least 25% of the capital of the first company or (iii) if a third company directly owns at least 25% of the capital of both the paying company and the receiving company.[39]

38. *See OECD*: Thin Capitalisation, 1986, para. 8 and *Piltz* in Cahiers, vol. LXXXIa, Permanent Establishments of Banks, Insurance Companies and Other Financial Institutions, 1996, p. 92 *see also Burmeister*: Unternehmensfinanzierung im Internationalen Steuerrecht, 2003, pp. 36 et seq. and *Brown* in Cahiers, vol. 97b, The Debt-Equity Conundrum, 2012, p. 28.

39. It should be noted that the ECJ has stated in the *Beneficial owner* cases (joined ECJ cases on dividends (PSD) C-116/16 and C-117/16 and the joined cases on interests (IRD) C-115/16, C-118/16, C-119/16, C-299/16) that there is, in EU law, a general legal principle that EU law, including the IRD, cannot be relied on for abusive or fraudulent ends and that a Member State *must* in just instances refuse to grant the benefit of the provisions of EU law, including the IRD, despite the absence of provisions of national law providing for such a refusal.

[5] Overview of Tax Consequences

The distinction between debt and equity is still essential in international tax law. Table 2.2 summarizes the tax consequences associated with the debt-equity distinction in general terms not taking into consideration any details of domestic law.

Table 2.2 Tax Consequences Associated with Debt and Equity

Financing	*Taxpayer*	
	Issuer	*Investor*
Equity	Dividends are not deductible. *Modification*: Allowance for Corporate Equity regimes or actual deduction for dividends.	Dividends are taxable income in the hands of the shareholder, regardless of whether they arise from ordinary dividends. Withholding tax in the source state is levied in the hands of the investor. *Modification*: affiliation privilege /participation exemption.
Debt	Interest payments are deductible in the income tax calculation. *Modification*: Limitations on deductibility (thin capitalization, EBITDA rules, etc.)	Interest is taxable income in the hands of the creditor. *Modification*: International tax havens and special tax regimes.

As seen above, debt financing often reduces the tax base of the issuer, while increasing the tax base of the investor. Equity financing, however, often does not reduce the tax base of the issuer nor does it increase the tax base of the investor. Hence, a system of *one level of tax* seems to be pursued, a tax either at the level of the issuer (equity) or at the level of investor (debt).[40] As such, purely from a tax perspective debt is preferred over equity if the taxation of the issuer is higher than the taxation of the investor (including withholding taxes). This conclusion is of course simplified.

Jacobs has carried out a comprehensive study on the difference between a German parent corporation opting for either debt or equity financing of a domestic, French, Japanese and United Kingdom subsidiary.[41] Jacobs concluded that it is not possible in general to say whether debt or equity financing should be preferred (a conclusion which remains valid today). The conclusion rests on a multitude of factors, which may dramatically affect the benefit of the financing alternatives. Such factors include the following:

40. *See also Brown* in Cahiers, vol. 97b, The Debt-Equity Conundrum, 2012, p. 20.
41. *See Jacobs* in StuW 1996/1: Steuerliche Vorteilhaftigkeit des Einsatzes von Eigen- oder Fremdkapital bei der international Konzernfinanzierung pp. 26 et seq.

- Which taxes are included: taxes in the country of the foreign subsidiary, withholding taxes and shareholder taxation?
- The actual situation of the foreign subsidiary in terms of taxes, in other words is the subsidiary profitable or lossmaking?
- Whether the actual form of financing is classical debt, equity or hybrid financing?
- Are there any foreign limitations according to thin capitalization rules?
- Is a foreign financing corporation interposed?
- How is the double taxation of dividends and interests relieved, by way of exemption, indirect credit or fictitious credit?

Even if the conclusion rests on a multitude of factors, the mere complexity of the debt versus equity distinction and the unequal treatment in itself give rise to some tax policy considerations in relation to maintaining a tax distinction of the debt versus equity.

§2.04 TAX POLICY CONSIDERATIONS

[A] Is a Distinction Between Debt and Equity Needed?

The debt versus equity distinction is well established in many countries even though it has little underlying theoretical basis. Most tax law commentary has argued that equity and debt fulfill the same economic function and thus should not be taxed differently.[42]

This issue has been analyzed from a tax policy perspective by Emmerich in United States (US) Law, which also seems relevant in the context of other jurisdictions.[43] The analysis shows that the attempts by the US Courts and the Treasury to enforce the debt versus equity distinction have failed because the traditional rationale for the distinction is both impracticable and based upon factually incorrect premises.

The classical distinction in US Tax Law between shareholders and creditors (lenders) and, therefore, between dividends and interest, was drawn by the Second Circuit in *Commissioner v. O.P.P. Holding Corp.* (76 F.2d 11 (2d Cir. 1935). In this often-quoted distinction the Court stated that:

> [t]he shareholder is an adventurer in the corporate business; he takes the risk, and profits from success. The creditor, in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives … .

42. *See Mackenzie* in JAFRA vol. 1, issue no. 1, 2006, pp. 31 et seq. *Rumble & Wood* have argued in an Australian context that there should be no difference in the way debt and equity instruments are taxed. *See Rumble & Wood* in Intertax, vol. 31, 2003, pp. 409 et seq. Hariton has argued in the following way: "The task of drawing a line between equity and debt might be simpler if there were a more palpable reason for treating them in a different way. After all, equity and debt are both claims upon the assets of a corporation, and both are acquired in exchange for capital. The only economic distinction between them is the variability of their returns … ." *See* Tax Law Review 1988, p. 775.
43. *See Emmerich* in University of Chicago Law Review, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, vol. 52, 1985, pp. 118 et seq.

Emmerich states that this view is based on the notion that, because the shareholder benefits from investing through the corporate form, he should not be allowed to extract his profits until after they have been taxed at the corporate level.[44] Conversely, it is stated that the cost of borrowing money (interest) is seen as an ordinary and necessary cost of doing business that should no more be met out of after-tax dollars than should workers' salaries or the cost of raw material.[45] The author finds no better explanation stated by the Congress and concludes that the deductibility of interest is apparently so intuitively that Congress has deemed it unnecessary to explain Internal Revenue Code (IRC) § 163(a) or its predecessors.[46]

Despite the intuitive appeal and the actual use of the distinction as often based on the O.P.P. case and the like, it may be stated that the Court's reasoning does not successfully draw a principled distinction between debt and equity.[47] In conclusion, it is held that the O.P.P. Holding standard has proven to be essentially empty which has resulted in a lack of consistency and clarity.[48]

Emmerich then turns to financing theory in order to see whether the discipline provides a principled distinction between debt and equity. Based on the propositions by Modigliani & Miller, it is concluded that finance theory does not support a principled distinction between debt and equity. Any attempt to classify instruments as either debt or equity in a principled fashion is likely to be arbitrary in practice and will encourage wasteful efforts by tax planners to create instruments that take advantage of whatever line is drawn.[49]

Nevertheless, the history of debt and equity taxation in many countries shows that debt and equity have actually been treated differently for tax purposes.[50] A difference between the two forms of financing does currently exist and is highly

44. *Id.*, p. 122.
45. *Id.*, p. 122.
46. *Id.* fn. 23.
47. *Id.*, p. 122, stating: "… The distinction fails because the difference between creditor and shareholder is, in an important sense, one of degree only. Both shareholders and creditors contribute capital to the corporation in the expectation that the corporation will be able to use this capital productively and return it to them along with a share of the resulting gain. Furthermore, it is inaccurate to characterize all shareholders as necessarily bearing more risk than all creditors. The degree of risk to which an investor is exposed, and the potential payoff that he can expect, can vary more between the bond of one company and the bond of another than between the debt and stock of the same company … ."
48. *Id.*, p. 128.
49. The author's rationale is seemingly based on fairness arguments. It is stated: "Accordingly, the market will always respond with new instruments to take advantage of any line drawn by the Service. Such a response tends to be especially strong from large, publicly held corporations that constantly raise new capital, employing professional advisors to aid them in doing so. Investment banker and tax lawyers monitor the latest tax regulations and develop instruments having the desired tax and financial characteristics, thus obtaining large tax savings for their clients. As a result, those corporations that invest in intensive tax planning enjoy an advantage over those that do not."
50. An exception would be a Comprehensive Business Income Tax (CBIT) or a Cost of Capital Allowance (COCA) tax system as mentioned below in section §2.04[D]. *See also*, for example, Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 7.

unlikely to change in the near future.[51] The question remains about what should be done with the distinction: should it be abolished or preserved?

[B] Proposals to Improve the "Line-Drawing"

It has been argued that any line drawn between debt and equity is inherently arbitrary and that a clear line is, therefore, essential if a tax system is to be built around that line. Such a tax system can include measures imposing a maximum debt/equity ratio, earning-based limitations and/or a deduction with respect to notional interest on equity. Issuers and investors can then develop products *with no bells and whistles* that accurately reflect the desired risk/reward trade-off and are intended to ensure that the instrument receives the desired tax treatment.[52]

A number of scholars have developed proposals with the aim of improving the line-drawing. One of the simplest proposals is presented by Emmerich.[53] On the basis of a foregoing analysis, Emmerich proposes a test to govern the classification of debt and equity for instruments issued in arm's-length transactions by large, publicly held corporations. Under the proposed test, financial instruments that *closely resemble straight debt* (based on a classic notion of debt) would be treated as debt unless they were sold as packages of separately salable debt and equity instruments. In other words, the author simply suggests that debt treatment should only be granted to debt instrument which carries the primary characteristics of debt. In the words of the author, this is not to untie the Gordian knot but simply to cut it.[54]

Another attempt to improve the line-drawing is the bright-line test suggested by Thompson.[55] In general terms, Thompson finds that such rules would have the effect of only treating those instruments that are clearly debt as debt for income tax purposes and, thus, only they would curtail the erosion of the corporate tax base.[56]

Schön argues that the debt-equity distinction should endure. According to the author, the debt-equity distinction has not broken down, but in (urgent) need of repair and a common understanding of its underlying policy options.[57] Schön demonstrates that the debt-equity divide cannot easily be dismissed and that equity treatment, as

51. See *Mackenzie* in Journal of Applied Research in Accounting and Finance, Taxation as a Driver for Designing Hybrid Securities, vol. 1, issue no. 1, 2006, p. 35.
52. *See also Brown* in Cahiers vol. 97b, The Debt-Equity Conundrum, 2012, p. 42.
53. *See Emmerich* in University of Chicago Law Review, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, vol. 52, 1985, pp. 118 et seq. (p. 120).
54. *Id.*, p. 148.
55. *See* Thompson *in Tax Notes; A Suggested Approach to Debt/Equity Issues and Leveraged Acquisitions, January 23, vol. 42, 1989, pp. 483 et seq.*
56. *Id.*, p. 485.
57. *See Schön*, in Bulletin for International Taxation: The Distinct Equity of the Debt-Equity Distinction, vol. 66, 2012, p. 502. *See*, moreover, *Schön* et al.: Debt and Equity: What's the Difference? A Comparative View, Max Planck Institute for Intellectual Property, Competition and Tax Law Research Paper Series No. 09-09. *See also Schön* et al. in British Tax Review (BTR), No. 2, Debt and Equity in Domestic and International Tax Law—A Comparative Policy Analysis, 2014, pp. 146–217.

opposed to debt treatment, should refer to the power of the company to decide on the distribution of funds.[58]

Bärsch has also developed a number of different reform options and has identified two coordinated domestic tax law classification approaches. These proposals share the idea that the coordinated domestic tax classifications of the remuneration of equity or debt should be based solely on genuine tax rules since reference to domestic company law classification increases complexity.[59] Bärsch argues that two alternatives are available.[60]

The first being that the classification should rely on the distinctive characteristics of the instrument and that it seems advisable that instruments should be classified as debt only if: (1) the capital borrower is both noncontingently obliged to provide a noncontingently determined repayment amount and the corresponding repayment date is effectively not longer than thirty years after the issuance and (2) this repayment amount is not subordinated to all other creditors of the capital borrower. Finally, it is concluded that the tax classification shall disregard the remuneration as a decisive characteristic.

As a second nonharmonized domestic classification approach, Bärsch argues that this should avoid an entirely new set of decisive characteristics by making reference to the foreign domestic tax classification. In this context, the author prefers an approach where reference is made to the domestic tax classification of the source country either in a harmonized way or by means of tiebreaker rules.[61]

Lastly, as another approach, Bärsch introduces options that depart from the coexistence of source-based and residence-based taxation, but which in principle do not depart from the debt-equity dichotomy. Here different suggestions are developed such as introducing withholding taxes on interest payments and restrictions on deductibility. The author recommends introducing tax exemption for interest payments as well as dividend payments in the case of an effective corporate income taxation in the source country.[62]

[C] Proposals Eliminating the Effects of the Current Debt-Equity Distinction

Plumb has argued a need for legislative reappraisal under the assumption that there is nothing more complex than trying to draw a line, which does not exist.[63] Plumb stated:

> that it is time for Congress to reexamine the purposes, if any, served by distinguishing debt from equity and, to bring that fruitless exercise to an end … .[64]

58. *See Schön*: The Distinct Equity of the Debt-Equity Distinction, in Bulletin 2012, p. 502.
59. *See Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context—Issues and Option for Reform, 2012, p. 306.
60. *Id.*, p. 323.
61. *Id.*, pp. 323 et seq.
62. *Id.*, p. 324.
63. *See Plumb* in Tax Law Review: The Federal Income Tax Significance of Corporate Debt. A Critical Analysis and a Proposal, vol. 26, issue no. 3, 1971, pp. 619 et seq.
64. *Id.*, p. 620.

And further that:

> The truly pertinent questions, relevant to the soundness of the tax system, are whether the tax laws should discriminate against equity capital and discourage the formation of new and risky enterprises […], whether the tax laws should compel corporations, if they are to remain competitive, to make the maximum possible use of debt financing, even to an extent that may be unhealthy in the case of outside debt and unrealistic in the case of debt to shareholders, or whether the tax laws should be as neutral as possible in their effect upon such business judgements, and finally, whether an equitable and efficient tax system can longer tolerate a self-selected tax burden, permitting a taxpayer, by exercising his admittedly free right to choose a capital structure, to determine for himself how large a tax shall be borne for the privilege of doing business in corporate form.[65]

Plumb evaluates different possible solutions to the problem. One method is by making interest a nondeductible expense for CIT purposes. This possibility is rejected since such a proposal in Plumb's view would resolve the problem, but only shift the focus of the tax minimization problem, by encouraging such alternatives to borrowing (or to credit purchases) as the leasing or licensing of property, as well as the sale and leaseback of property the corporation already holds.[66] Another possibility is to allow a deduction for dividends paid. Yet another proposal is to introduce debt-to-equity ratios in general.

Hariton has tried to develop a more structural understanding by introducing the alternative structural approach stating:

> Perhaps I should admit at this point that I feel rather silly listing attributes as separate characteristics and piling them up on a scale, all to support my position that an instrument should be respected as debt for tax purposes.

The real question, to the author's mind, is not how many debt characteristics an instrument possesses, but rather to what extent the instrument insulates the investor from the risk and rewards of the issuer's business. This question only has meaning in the context of the relationships between different classes of investors in the corporation.[67] Equity confers more business risk than does debt in the same corporation. Therefore, according to Hariton, to answer the question one must consider the rights conferred by other investments in the capital of the issuer, what other capital exists to support the rights conferred by other investments in the capital of the issuer and what other obligations must first be met by the issuer.[68] Accordingly, it is not possible to characterize an instrument as equity or debt by reference to a checklist of abstract attributes that equity and debt supposedly possess. The relationship between the different classes of investors in the corporation is not on the checklist of factors

65. *Id.*, pp. 620-621.
66. *Id.*, p. 626.
67. *See Hariton* in Tax Law Review, vol. 43, The Taxation of Complex Financial Instruments, 1988, p. 522.
68. *Id.*

presented above. The specific questions of interest according to Hariton are the following:[69]

(1) How much equity capital supports the investor's rights?
(2) How much debt capital is senior to it?
(3) To what extent will the investor participate in the issuer's profits?
(4) What rights, if any, will the equity still have if the lender loses money?

The traditional factors are only useful insofar as they refer to these questions.[70] By way of an example, Hariton mentions the traditional factors regarding subordination and thin capitalization, which are not yes-no questions but rather concern how much equity exists to support the issuer's promises and what other promises the issuer has made that have priority.

[D] Proposals Eliminating the Debt-Equity Distinction Itself

It has also been suggested that the distinction between debt and equity be eliminated for purposes of characterizing taxable income (or deductible expenses). This approach includes scenarios where deductibility is not allowed for yield on debt as well as equity. Another well-known proposal is the introduction of the so-called ACE regimes (Allowance for Corporate Equity).

Kleinbard suggests a "Cost of Capital Allowance" system (COCA), where the allowance of the issuing corporation would equal a set rate multiplied by its invested capital.[71] Under the COCA proposal, every business enterprise would receive an annual allowance for the cost of the capital deployed in its business. That allowance would be uniform regardless of the form the capital took and regardless of the actual creditworthiness of the issuer.[72] The COCA rate would be applied to the issuer's total capital to determine the issuer's annual COCA.[73]

Andrews suggested granting issuing corporations a statutory allowance on qualified capital contributions. Andrews would, however, restrict the deduction to

69. *Id.*
70. *Id.*
71. *See Kleinbard* in Tax Notes, vol. 106, The Business Enterprise Income Tax. A Prospectus, 2005, pp. 101 et seq., and *Kleinbard* in Taxes, Beyond Good and Evil Debt: A Cost of Capital Allowance System, vol. 67, 1989, pp. 943 et seq.
72. In a recent Swedish reform proposal, a modified CBIT model was proposed (cf. SOU 2014:80) and (for the commentary *see Lodin* in Nordic Tax Journal: An Overview of the Proposal of the Swedish Government Committee on Corporate Taxation, issue 2, 2014, pp. 43 et seq. The model would disallow deduction for cases in which financial costs exceed the financial income of a company, while also lowering the effective corporate tax rate from 22% to 16.5%. *See also* Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 7.
73. A system based on COCA has been found to be too radical by Kau. *See Kau* in Taxes, Carving Up Assets and Liabilities-Integration or Bifurcation of Financial Products, vol. 86, 1990, pp. 1003 et seq. (p. 1005).

newly contributed equity capital to avoid a tax windfall to current equity holders who did not expect a tax benefit when they purchased their shares.

The COCA deduction would appear to reduce the debt-equity distinction, although it only focusses on the corporate-level consequences of the proposal. Taking into account the investor-level consequences, the COCA deduction proposal would, in the view of Kau, invert the bias toward the issuing of debt, creating a new bias in favor of issuing equity.[74]

Economic theory has developed different solutions with the objective of neutralizing the tax treatment of debt and equity. The model 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 CIT treats equity.[75] There are, however, currently no real-world examples of CBIT.[76]

ACE has been on and off tax reformers' agendas since the 1980s.[77] Since then, proponents have repeatedly argued in favor of such a tax. The ACE has a number of interesting features.[78] 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. However, ACE systems may also be seen as a means to stimulate equity investment in the corporate sector of the country in question. In the present economic environment, ACE may be seen as a way to increase the attractiveness of a capital importing country.

In theory, the allowance for corporate capital (ACC) is even more neutral. Under the ACC, 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.[79]

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74. *Id.*, p. 1141.
75. *See also* Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 7.
76. *See de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011, p. 16.
77. *See Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 3. A firmer reform proposal was presented by the Institute for Fiscal Studies in 1991: *Deveraux & Freeman:* A General Neutral Profits Tax, Fiscal Studies vol. 12, 1991, pp. 1-15 and *Gammie* in European Taxation, Corporate Tax Harmonization: An Ace Proposal, vol. 31, 1991, pp. 238 et seq. *See also* the Institute for Fiscal Studies, Miirlees Review, Reforming the Tax System for the 21st Century, Tax by Design, pp. 421-425 and *Blessing* in Bulletin for International Taxation: The Debt-Equity Conundrum - A Prequel, vol. 66, 2012, p. 212.
78. *Id.*, pp. 4 et seq.
79. *Id.*, p. 211. *See also* the Final Report from the European Commission written by the *Centre for European Economic Research (ZEW) GmbH* in Taxation paper No 65: The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates, dated October 25, 2016, Chapter 7.

§2.05 CONCLUSION

The distinction between debt and equity is considered to be one of the fundamental and yet unsolved issues in international tax law. It cannot be denied that the debt-equity distinction has caused and continues to cause some concern in the area of international tax law. The primary concern among policy makers involves tax-motivated excessive leveraged financing and tax arbitrage. From a business perspective, the distinction causes uncertainty and potential double taxation. Consequently, the distinction does not seem fully capable of meeting the challenges and needs of the twenty-first century. Some degree of improvement seems to be in place. But which solutions should be adopted and is there one solution to fit all?

Many possible solutions have been presented above, yet no single approach is globally predominant. It seems that many of the responses in recent times aim at the symptoms of the problems rather than their root causes. This is demonstrated by the increase in interest limitation rules as well as linking rules. The current trends following the OECD/G20 BEPS project, the EU and US initiatives do not solve all the problems, but merely ensure that certain mismatches are less likely to occur in the future international tax landscape. A more solid solution would require fundamental tax reform, either through unilateral neutralization efforts such as the introduction of ACE regimes or by harmonizing the classification on a global scale, although such a solution would obviously be less feasible.