



DEBT AND EQUITY: WHAT'S THE DIFFERENCE?
A COMPARATIVE VIEW

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A. The Debt-Equity Divide and its Legal Consequences

I. Does it matter at all?

The notions of debt and equity have been created in the context of civil law, in particular contract law, corporate law and insolvency law. They serve as categories for particular combinations of financial risk and rewards, voting and control rights under a contract providing funds for a business¹. This is reflected in accounting law where the distinction between debt and equity plays a major role when the financial status of an enterprise is shown to the general public².

From this point of origin, the distinction between debt and equity has found its way into income tax law which traditionally builds upon economic transactions shaped by contractual and statutory rules under private law. Nevertheless, not every distinction which makes sense under civil law also makes sense in the context of taxation. Starting from the basic concept of income taxation the only relevant question should be: Does an individual taxpayer derive any taxable income at all? Under the SHS-concept of income, we would simply look at the increase in financial means attributed to a taxpayer. Insofar it goes without saying that the contractual situation of a taxpayer always makes a difference: fixed interest payments arising from a debt claim regularly do not represent the same amount of financial means (i.e.: taxable income) as volatile profits derived from an equity stake. But when we make this self-evident statement we do not really employ the debt-equity divide as a distinctive feature. We only look at the financial outcome irrespective of the qualification of the underlying instruments. Nevertheless, 100.000 € earned from equity and 100.000 € earned from debt will be taxed the same way. Insofar one could easily say that under very basic principles of income taxation the debt-equity divide should not play a role at all. To be sure, this statement does not have to be modified if we replace an SHS income tax by a cash-flow-oriented consumption tax. The inclusion of inflowing cash items and the deduction of out-flowing cash items do not require any legal distinction between debt and equity instruments at all.

¹ RICHARD A. BREALEY/STEWART C. MYERS/FRANKLIN ALLEN, *Principles of Corporate Finance*, 9th Ed. (2008) p.385 et seq.; JEAN TIROLE, *Theory of Corporate Finance* (2006) p.75 et seq.

² International Accounting Standard 32 (Financial Instruments: Presentation).

The debt-equity divide does, however, play a role under income taxation rules when we enrich income taxation by further technical and political sophistications. These refer to the definition of the tax base, the tax rate and the taxable subject. Basically, there are three situations where this comes to the fore. They come up under individual income taxation (the “partnership situation”), corporate income taxation (the “shareholder situation”) and international income taxation (the “source situation”).

II. Individual Income Tax: The “Partnership Situation”

Under individual income tax the debt-equity divide has to be taken into account when it comes to the distinction between a taxpayer carrying on a business or a trade (the equity holder) and a taxpayer deriving (investment) income from a debt claim (a creditor).

This starts with procedural matters: A businessman and his creditor will not file a joint tax return on the combined income they derive from the firm owned by the businessperson. But when the financial position and the control rights of the financier are strong enough to call him a “partner” of the businessman, a joint assessment might follow notwithstanding that the overall income will (as a second step) be divided and allocated to each individual partner with respect to the financial amount they finally derive from the common investment.

In addition to these procedural requirements, tax legislation may also create substantive consequences of the debt-equity-divide. An evident example is an additional tax on business income (like the German trade tax) which is not applicable to interest income in the hands of a private investor.

More common in many countries are distinctions with respect to the measurement and timing of income. In most jurisdictions, business income is measured in accordance with the accruals method (regularly following commercial accounting) while privately-held income from debt instruments is taxed under the cash method³. Insofar, there will be timing differences arising from the distinction

³ HUGH AULT/BRIAN ARNOLD, *Comparative Income Taxation*, 2nd Ed. (2004) p.243 et seq.

between being a partner in the commercial enterprise or a mere creditor of the entrepreneur, e. g. when payments are postponed until the financial instrument reaches maturity.

When it comes to capital gains and capital losses, the tax consequences of the characterisation of financial instruments as debt or equity positions might even go further than timing differences. In many continental countries capital gains are taxable only in the context of business income while capital gains and capital losses from privately-held financial assets are not relevant for tax purposes at all⁴. The taxability of a gain from the sale of a financial instrument to a third party might therefore depend on the nature of the participation. On the other hand, it may happen that the partner in a commercial partnership will be able to set-off a loss in value of his stake against positive income from other sources while the holder of a debt instrument will not enjoy the same relief if his asset loses value (e.g. in the course of the insolvency of the debtor).

Recent legislation in many countries has reinforced this schedularisation of individual income taxation, adding more and more consequences to this distinction. In many countries you find specific tax relief for business income (e.g. a reduced tax rate in order to fuel investment) which is not available for holders of debt instruments. On the other hand, hard and fast rules on “withholding taxes” are spreading around in Europe and beyond which only apply to income derived from debt instruments. The most prominent example are the rules on exchange of information and withholding taxation under the EU Savings Directive which are explicitly limited to “interest” payments and cannot be extended without further legislation to income derived from equity instruments⁵.

Nevertheless, the application of such rules on withholding taxes following the characterisation of a contractual position as a debt instrument might also turn out to be advantageous for the taxpayer, e.g. when domestic tax law prescribes that the withholding tax is a final one so that no formal assessment (including application of higher mainstream income tax rates) will follow (this is the case

⁴ AULT/ARNOLD *supra* (note 3) p.198 et seq.; WOLFGANG SCHÖN, Capital Gains Taxation in Germany, *British Tax Review* (2006) p. 620 et seq.

⁵ Art.6(a)(b) of the Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments (O.J. L 157 of 26th June 2003 p.38); a recent Commission proposal for an extension of this notion upholds the basic distinction between interest and dividends (Proposal for a Council Directive amending Directive 2003/48/EC,

in Austria, France and Germany). At this point it should be noted that the concept of a Dual Income Tax tries to alleviate this distinction by granting a low proportional tax rate to both debt and equity holders, but as long as Dual Income Taxation is not introduced everywhere, the aforementioned distinctions will play a role⁶.

III. Corporate Income Tax: The “Shareholder Situation”

The most prominent feature of the debt-equity divide concerns the treatment of debt instruments in the context of corporate income taxation. Corporate income taxation is shaped by the hypothecation of the corporate entity as a taxpayer in its own right (although there is no doubt that it is in fact nothing more than a bundle of contracts). This legal fiction leads to a twofold consequence: At the level of the corporation, a specific tax (the corporate income tax) is levied, and at the level of the shareholder an additional layer of individual income tax is applied. As a consequence, return on equity is taxed twice. Debt instruments, on the other hand, lead to deductibility of payments at the level of the corporation and to one-layer taxation in the hands of the debt holder. Against this background, a large part of the debate on the debt-equity divide, in particular by economists⁷, is devoted to the presumed bias of corporate income taxation in favour of debt instruments.

It goes without saying that this fundamental divide loses its force insofar as corporate income tax is integrated into individual income tax, e.g. by imputation systems, by full or partial tax exemptions for dividends or by reduced tax rates on corporate profits. Nevertheless, recent moves around the world for lower corporate income tax rates which are not accompanied by comparable reductions for individual income tax rates, have led to a new divide: under the new regime, the tax burden on (retained) corporate profits might be even lower than the tax burden on income from debt instruments. From a policy-oriented background it is not easy to understand why the same distinction

COM(2008)727 final, Explanatory Memorandum, p.6 et seq.); see also CHRISTIANA HJI PANAYI, *The Proposed Amendments to the Savings Directive*, *European Taxation* (2009) p.179 et seq.

⁶ GERMAN COUNCIL OF ECONOMIC EXPERTS/MAX PLANCK INSTITUTE FOR INTELLECTUAL PROPERTY, COMPETITION AND TAX LAW/CENTRE FOR EUROPEAN ECONOMIC RESEARCH, *Dual Income Tax: A Proposal for Reforming Corporate and Personal Income Tax in Germany* (2008) para 58 et seq.

⁷ EUGENE F. FAMA/KENNETH R. FRENCH, *Taxes, Financing Decisions, and Firm Value*, 53 *Journal of Finance* (1998) p.819 et seq.; JOHN R. GRAHAM, *How Big are the Tax Benefits of Debt?* 55 *Journal of Finance* (2000) p.1901 et seq.;

which has led to a particular high tax burden under the old paradigm does lead to a particularly low tax burden under the new paradigm.

It should be noted at this point that the specific challenge which the existence of a separate corporate income tax forms for the debt-equity divide does not mean that the relevant consequences which have been mentioned in the context of individual income taxation go away. Topics like “accruals method vs. cash method”, deductibility of capital losses or the application of a final withholding tax have to be addressed for the distinction between corporate bondholders vs. corporate shareholders as well. Nevertheless, there are modifications: while the shareholder in a business corporation is generally not regarded by tax law as a businessperson himself, a partner in a commercial partnership receives business income and is treated accordingly.

IV. International Income Tax: The “Source Situation”

Under international tax law, the basic question refers to the allocation of taxing rights between jurisdictions with respect to certain items of income. This question comes up when the recipient of the capital (e.g. a corporate entity but it can be as well an individual taxpayer) and the supplier of the capital reside in two different countries. In this context, the distinction between debt and equity shows its most powerful consequences.

Before we go into the details it should be recognised that any equity-treatment of a financial instrument in the afore-mentioned “partnership situation” or “shareholder situation” naturally leads to taxation in the country of source. If the foreign resident financier is regarded as a partner in a commercial enterprise which is carried on in the country of source, the local activity of the enterprise will be characterised as his permanent establishment, leading to source taxation under Art.5 and 7 OECD Model Treaty. If the foreign financier is treated like a shareholder under domestic tax law, the payments to him will not be deductible at the corporate level and therefore be taxed at source (via residence taxation of the local company) as well. There may even be an additional withholding

JEFFREY K. MACKIE-MASON, *Do Taxes Affect Corporate Financing Decisions?*, 45 *Journal of Finance* (1990) p.1471 et seq.; MERTON H MILLER, *Debt and Taxes*, 32 *Journal of Finance* (1977) p.261 et seq.

tax on the out-flowing dividends under respective unilateral tax law and bilateral double taxation conventions.

But it is important to note that domestic tax treatment does not give the final answer to the problem of the allocation of taxing rights regarding income arising from debt claims. It is possible that payments which are regularly treated as deductible business expenditure at the level of the debtor are nonetheless subject to tax in the source state. This can be achieved by alternative methods.

Firstly it is well known that domestic tax legislation can restrict the deductibility of interest payments to domestic and foreign creditors (within the framework of supranational law like European Community Law) and that recent years have seen a spread of legal techniques to prevent out-flowing interest payments from leaving a jurisdiction untaxed, in particular in the context of group taxation⁸. Most prominently, Germany, Italy and the United Kingdom have undergone substantial changes of domestic tax law in order to stop re-allocation of corporate profits by means of financial instruments.

A second chance to tax the emoluments of debt instruments in the country of source is the limited tax liability of the creditor which can be effectuated via a withholding tax. Insofar, two approaches can be perceived: A far-reaching technique tries to assert tax jurisdiction on mainstream interest income in order to achieve widely equal treatment between debt-based and equity-based income. Depending on the respective provisions, this withholding tax on interest payments may substitute for the withholding tax on dividends or for the underlying corporate income tax or for both. But some countries do not provide for a legal basis to tax portfolio interest in the hand of a foreign resident taxpayer at all (e.g. France, Germany and the United States); many others have waived their

⁸ ANOUC VAN DEN BERG VAN SAPAROE, Optimizing the Interest Deduction Rules – A Never-Ending Story, *European Taxation* (2009) p.3 et seq.; MICHAEL J. GRAETZ, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, *IBFD-Bulletin* (2008) p.486 et seq.; TIM EDGAR/JONATHAN FARRAR/AMIN MAWANI, Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis, *56 Canadian Tax Journal* (2008) p.803 et seq.; PASCAL HINNY, General Report: New Tendencies in Tax Treatment of Cross-Border Interest of Corporations, *CDFI 93b* (2008) p.15 et seq.

right to tax such out-flowing payments in their double taxation treaties. Intra-group payments are more or less exempt from withholding tax under the European Interest-Royalty-Directive⁹.

Against this background, a widespread approach does not strive to tax all out-flowing interest payments but simply moves the dividing line between debt and equity in order to catch a larger amount of foreign-resident income by virtue of a withholding tax on dividends under the relevant unilateral and bilateral rules. Under this technique, particular payments are treated as deductible interest for the purpose of domestic tax law but as a taxable dividend for the purpose of international tax law.

Putting things together, return on equity is regularly taxed in the country where the business is carried on (e.g. by a local corporate entity) while return on debt is taxed in the country where the holder of the debt instrument is resident. The debt-equity divide seems to prove decisive for the allocation of taxing rights at the international level.

V. Some General Remarks

The foregoing analysis has shown that the debt-equity divide has to be taken into account in the framework of individual income taxation (the “partnership situation”), of corporate income taxation (the “shareholder situation”) and international income taxation (in the context of “source and residence” based taxation of corporate profits). One caveat is in order: it is by no means certain that the distinction between creditors and partners under individual income tax, the inclusion of payments into the corporate profit under corporate income tax law and the allocation of taxing rights between countries should follow the same line. In particular it should be accepted that the treatment of payments as deductible business expenditure at the level of a company is not automatically followed by a waiver of the relevant jurisdiction to tax these payments in the hands of the (foreign resident) recipient. To the contrary, as the consequences of the debt-equity divide are quite diverse in the mentioned fields of tax law, it would be a surprise if the same measuring rod should be applied in order to decide the outcome of so many different tax provisions.

⁹ Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States of 3rd June 2003 (O.J. L 157 of 26th June 2003 p.49 et seq.).

There are two additional topics which are not explicitly addressed in the article: One is international tax arbitrage. It is well known that the debt-equity divide does not only lead to repercussions within the tax framework of a single country, an additional feature are divergent characterisation of cross-border financing contracts under the respective domestic tax laws (including application of double taxation conventions). Diverging characterisations of a particular financial instrument as equity in one country and as debt in the other country may result in double taxation or double non-taxation (“white income”)¹⁰. As this article tries to identify convincing solutions for the general distinction between debt and equity in the tax arena it does not deal at length with such conflicts of qualification.

A second – practically extremely important – aspect is intra-group financing. Although it is well known that intra-group financing lies at the heart of profit shifting within multinational enterprises and is therefore high on the political agenda, any policy analysis of intra-group financing has to build on a solid analysis of debt and equity in the general situation of financial instruments provided by external financiers rather than by internal shareholders. If and so far as it makes sense to distinguish between debt and equity under domestic and international tax law, it would be a second step to analyse whether this outcome should be changed for intra-group debt. But this goes beyond the scope of this article.

Against this background, the following comparative presentation is meant to show the different ways in which debt and equity are distinguished in several jurisdictions. The analysis includes Austria, France, Germany, Switzerland, the United Kingdom and the United States.

B. National Reports

I. Austria

¹⁰ JAMES A. DUNCAN, General Report: Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions, CDFI 85a (2000) p.21 et seq.

1. Introduction

The assignment of financial instruments to either debt or equity under Austrian law has various legal consequences and effects. The criteria which are applied to the said distinction vary depending on the field of law, namely corporate law, accounting law and tax law. None of the relevant provisions contains a legal definition of debt or equity. Therefore, the following country chapter analyses the different criteria applied in Austrian law and tries to answer the question whether the distinctions made are justified

2. Corporate Law and Accounting Law

a) General Aspects of Debt and Equity

As far as Austrian corporate and accounting law is concerned, the focus is on the different functions of the financial capital. The legal position of the respective investor is crucial for this test.¹¹ Apart from the capital's finance function, liability and warranty aspects are very important. One of the criteria to distinguish debt from equity is the quality of the investor's participation. If he directly participates in the company's profits and losses, the capital is likely to be classified as equity. An equity investor usually receives a profit-related remuneration and the right to participate in management.¹² In contrast, a debt investor generally receives a fixed interest for his capital commitment irrespective of the company's profits. As he bears no risks except the risk of insolvency,¹³ he is not entitled to exert managing powers on the debtor.

There are certain financial instruments which combine characteristics of typical debt and equity. By developing these hybrid financial instruments, creditors and debtors strive for the maximum utilisation of positive legal consequences. Especially the different classification of the same financial instrument under corporate and tax law can be of strategic interest for the investor.

¹¹ KOFLER/PAYERER, in BERTL et al., Handbuch vol. IV, 53 (57 et seq., 72 et seq.).

¹² EBERHARTINGER, in BERTL et al., Handbuch vol. IV, 88 (89).

¹³ KREJCI/VAN HUSEN, GesRZ 2000, 54 (56).

Hybrid financial instruments are based on legal transactions between creditor and debtor governed by the law of obligations.¹⁴ The respective contractual structure determines the classification as debt or equity under corporate and accounting law. Typical elements of debt and equity have to be recognised and measured in order to decide how the hybrid financial instrument in question should be treated for corporate and accounting purposes. This shall be shown with respect to some major financial tools employed under Austrian law.

b) Silent Partnership (*Stille Gesellschaft*)

One of the instruments to raise hybrid capital is the undisclosed or silent partnership. In this case, the financier holds an undisclosed participation in the business of a commercial person including a share in profits and losses but no voice in the management of the debtor's company.¹⁵ Details can be found in secs. 179 - 188 UGB. The profit participation cannot be waived but it can be subject of further modification between the partners (sec. 181 para. 2 UGB). Thus, it is possible to pay part of the remuneration for the capital contribution irrespective of the existence of a real profit. Regarding the losses, however, the exclusion of any participation is possible (sec. 181 para. 2 UGB). In that case, the distinction between an undisclosed partnership and a participating loan can be difficult.¹⁶ In the event of insolvency, the given capital is regarded as a provable claim (sec. 187 para. 1 UGB). This is an element of typical debt instrument.

On the other hand, the financier has certain rights of verification (sec. 183 UGB). He can ask for a copy of the annual accounts and is allowed to check the commercial books and documents.¹⁷ Such a legal position is usually characteristic of equity capital. Yet, the participation in management is limited to gaining the information needed to specify the amount of the creditor's claim.¹⁸ Hence, the silent partnership is treated as debt for corporate and accounting purposes.

¹⁴ HEINRICH in: IFA, CDFI LXXXVa, 135, (135).

¹⁵ Vgl. SCHÖN, ZGR 1993, 210 (211); FRITZ, Gesellschaftsrecht, 54; KALSS/NOWOTNY/SCHAUER, Gesellschaftsrecht, 2/949.

¹⁶ KREJCI/VAN HUSEN, GesRZ 2000, 54 (62); KALSS/NOWOTNY/SCHAUER, Gesellschaftsrecht, 2/949.

¹⁷ KREJCI, in KREJCI, Reform-Kommentar UGB, sec. 183 m.no. 1.

The scope of freedom under corporate law allows the allocation of further rights to the financier. The parties can agree on a share not only in profits and losses but also in the latent gains; in this case, the undisclosed partnership is regarded to be „atypical“. ¹⁹ Also the financier’s participation in losses will not be excluded. In exchange, the financier will regularly be given management authorisation in order to have some influence on the company’s development. The contributed capital will then be treated as equity capital. ²⁰

c) Jouissance Rights (*Genussrechte*)

A very similar instrument are jouissance rights which are only mentioned in secs. 128 para. 2, 174 paras. 3 and 4 AktG and sec. 240 UGB. The legislator successfully leaves it to the practice to refine these financial instruments. ²¹ A jouissance right gives the creditor a claim under the law of obligations to participate in the company’s profits. ²² Apart from this proprietary interest, the financier is usually not entitled to any rights which a shareholder or partner would have. ²³ If a participation in losses is also excluded, the jouissance right should be treated as debt capital. ²⁴

On the other hand, the financier’s legal position can be quite close to that of a shareholder given the scope of discretion. Apart from the right to vote, he can have rights so similar to a shareholder’s that the characterisation of his position as equity capital is justified. ²⁵ A participation in losses or a very restricted right of termination, for example, indicate that the liability is not limited to a mere creditor’s position. ²⁶

¹⁸ FRITZ, *Gesellschaftsrecht*, 67; KALSS/NOWOTNY/SCHAUER, *Gesellschaftsrecht*, 2/965; EGGER/SAMER/BERTL, *Jahresabschluss*, 288 et seq.

¹⁹ LANG, *Hybride Finanzierungen*, 153.

²⁰ OGH 8 Ob 4, 5/95, *ecolex* 1996, 459 (460); OGH 8 Ob 39/95, *ecolex* 1996, 461; OGH 8Ob 7/95, ZIK 1996, 179; FRITZ, *Gesellschaftsrecht*, 67; HEINRICH, in: IFA, CDFI LXXXVa, 135 (136).

²¹ KREJCI/VAN HUSEN, *GesRZ* 2000, 54; WÜNSCH, *FS Strasser*, 871 (872, 874); NAGELE, in JABORNEGG/STRASSER, *AktG*, sec. 174 m.no. 27.

²² WÜNSCH, *FS Strasser*, 871 (879).

²³ KREJCI/VAN HUSEN, *GesRZ* 2000, 54 (57); WÜNSCH, *FS Strasser*, 871 (880).

²⁴ KREJCI/VAN HUSEN, *GesRZ* 2000, 54 (58).

²⁵ KREJCI/VAN HUSEN, *GesRZ* 2000, 54 (56 et seq.); GASSNER, *ÖStZ* 1986, 119 (123).

²⁶ KREJCI/VAN HUSEN, *GesRZ* 2000, 54 (56, 57).

The main difference between an undisclosed partnership and a *jouissance* right is said to be the pursuit of a common purpose. While the partners of a silent partnership agree on a purpose and advance it commonly, the holder of a *jouissance* right does not have any obligation of that kind.²⁷

d) Participating loan (*Partiarisches Darlehen*), Participating Bond (*Gewinnschuldverschreibungen*)

Participating loans and participating bonds are similar to *jouissance* rights with regard to their characteristic contractual structure. They grant a participation in profits on a contractual basis.²⁸ The creditor of a participating loan receives a share in profits for his financial commitment. He is not entitled to an interest in liquidation proceeds and does not participate in any losses. The participating loan is therefore treated as debt capital, although the profit-related remuneration is an element of typical equity capital.²⁹ A participating bond is a participating loan issued as a funded obligation. The profit-related remuneration is often combined with a partial fixed interest. As the participating loan, the participating bond is treated as debt capital.

e) Non-voting Preference Shares (*Stimmrechtslose Vorzugsaktien*)

Preference shares are shares in the legal sense but they are subject to some amendments regarding the participation in management. A waiver of voting rights can be agreed upon under secs. 12 para. 1, 115 et seq. AktG. In exchange, the preference shareholder is given a preferential right to the profit. Moreover, his right to participate in latent gains cannot be excluded. Apart from the right to vote, all management powers remain unlimited (sec. 116 para. 1 AktG), including the right to challenge decisions by the shareholder's assembly in court. Despite the preferential right to the profit and the waiver of voting rights, these preference shares are treated as equity capital.³⁰

3. Tax Law

²⁷ EBERHARTINGER, in: BERTL et al., Handbuch vol. IV, 88 (95).

²⁸ KREJCI/VAN HUSEN, GesRZ 2000, 54 (55).

²⁹ EBERHARTINGER, in: BERTL et al., Handbuch vol. IV, 88 (98).

³⁰ HEINRICH, in: IFA, CDFI LXXXVa, 135 (143).

a) General Aspects of Debt and equity

The Austrian income tax regime is not neutral with respect to debt and equity financing.³¹ Just as in corporate and accounting law, the distinction between debt and equity is of crucial importance as different legal consequences derive from the specific legal nature. The supply of capital as such is, in both cases, tax neutral.³² However, where the capital provided by means of a particular financial instrument can be classified as “equity”, the consideration paid with respect to this instrument is, in the sphere of the enterprise, tax neutral, i.e. not deductible as a business expenditure. This follows from sec.4 para.1 Individual Income Tax Act (IITA)³³ and sec.8 para.3 Corporate Income Tax Act (CITA)³⁴ for sole proprietorships, partnerships and corporations respectively.³⁵ Where, on the other hand, the capital provided qualifies as “debt”, the respective consideration is deductible (sec. 4 para. 4 IITA).³⁶

The classification of capital under Austrian income tax law follows, in principle, its own rules and disregards the treatment under corporate and accounting law.³⁷ Only where capital is supplied on the basis of corporate law rules and statutes (where, for example, capital is provided by a partner, limited or general, of a limited partnership; or a shareholder of a corporation), tax law follows corporate law and treats the capital as equity. This remains unchanged whenever these classical instruments under corporate law are furnished with atypical features. Non-voting preference shares, for example, are treated in the same way as ordinary shares. For hybrid financial instruments which are not based on corporate law but on the law of obligations, the autonomous tax notion of debt and equity can lead to divergent classification under corporate and tax law.

³¹ See, for example, RUPPE, in: BERTL et al., Unternehmensfinanzierung, 101 (101); STARINGER, in: BERTL et al., Eigenkapital, 253 (260).

³² See also RUPPE, in: BERTL et al., Unternehmensfinanzierung, 101 (106).

³³ Individual Income Tax Act (IITA) = Einkommensteuergesetz (EStG).

³⁴ Corporate Income Tax Act (CITA) = Körperschaftsteuergesetz (KStG).

³⁵ See also HEINRICH, ÖStZ 2000, 274 (275).

³⁶ See also EBERHARTINGER, in: BERTL et al., Handbuch vol. IV, 105; EBERHARTINGER, Bilanzierung, 147.

³⁷ See also EBERHARTINGER, in: BERTL et al., Handbuch vol. IV, 105; EBERHARTINGER, in: BISCHOF/EBERHARTINGER, Hybride Finanzierungsinstrumente, 119 (122); HEINRICH, ÖStZ 2000, 274 (275); HEINRICH, in: IFA, CDFI LXXXVa, 135 (143).

The tax treatment of the consideration received by the investor also depends on the context in which the capital is provided. The IITA specifically provides that income from capital investment is taxable. A major differentiation in Austrian income tax law, however, originates from the distinction with respect to the source (which “sphere”) the provided capital stems from. Where capital is provided from outside the business sphere (this covers claims constituting private assets of individuals but also assets owned by entities such as charitable associations), the fruit of the capital (such as dividends, interest) are taxable whereas capital gains remain untaxed unless they are covered by sec. 30 or 31 IITA (that is, speculation or sale of particular shares). Where, however, the capital provided stems from the investor’s business sphere, all income, including capital gains, is taxable under secs.21 to 23 IITA.

B) SILENT PARTNERSHIP (*STILLE GESELLSCHAFT*)

A silent partnership designed according to the default regime of the UGB is treated as debt under Austrian tax law. The debtor may deduct the consideration paid (sec. 4 para. 4 IITA) and the (typical) silent partner is taxable under the rules for either business income (secs. 21 to 23 IITA) or income from capital (sec. 27 IITA).

A silent partner subject to limited tax liability in Austria is also taxable in Austria with his proceeds from the silent partnership (sec. 98 para. 1 no. 3 or 5.a IITA). Austrian tax treaties usually cover proceeds from silent partnerships in the provision dealing with business profits (Art. 7 OECD-MC equivalent).³⁸ The tax treaties with the UK, Switzerland and the US (Art. 7 para.8 in each of these treaties) are examples for this practice. In the tax treaties with Germany and France, income from silent partnerships is generally³⁹ covered by the interest article whereupon this provision would grant the source state an unlimited right to tax in relation to Germany (Art. 11 para.2 DTC) and no right to tax in relation to France (Art. 11 paras.1 and 2 DTC).

In the case of a silent partnership designed to entitle the silent partner to a share in the latent gains as well as the goodwill of the debtor’s business, the entire arrangement is treated in the same way as

³⁸ See, in this regard, EAS 1218 of 26.01.1998, SWI 1998, 158; LANG, *Hybride Finanzierungen*, 180 et seq.; NEUNER, *Stille Gesellschaft im Abgabenrecht*, 4th ed., m.no. Q 10.

³⁹ Art. 10 para. 3 of the tax treaty with Germany is an exception to this.

an ordinary partnership, hence as equity.⁴⁰ For this result it is essential that the silent partner participates in the latent gains *and* the goodwill.⁴¹ The requirement of an active role in the management of the enterprise's business is negligible.⁴² The silent partner so participating in the business of another person is taxable with this business income in Austria, whether subject to unlimited or limited tax liability. Income from these atypical silent partnerships are usually covered by the provision for business profits in Austrian tax treaties (Art. 7 OECD-MC equivalent).

c) Jouissance Rights (*Genussrechte*)

Capital provided by means of jouissance rights may also have the legal nature of either debt or equity. Sec.8 para.3 no. 1 CITA provides that distributions connected to jouissance rights, which confer onto the investor a right to participate in the profits *as well as* the (notional⁴³) winding-up proceeds, are not deductible. This provision serves as a benchmark as to the dividing line between debt and equity when dealing with jouissance rights. A guaranteed minimum return may be agreed upon without forfeiting the status of equity if this minimum return is not granted in years of loss and if its economic significance is inferior to that part of the consideration which is dependent on an actual profit.⁴⁴ If one or both of the two elements of sec.8 para.3 no. 1 CITA are not met, the jouissance right is taxed as debt with the consequence of deductibility of the respective consideration in the hands of the issuer. The investor is, in principle, taxed on the income derived from the jouissance rights under the provisions for business or capital income (secs. 21 to 23 or 27 IITA). If the capital is invested by a corporation, however, the participation exemption provided by sec. 10 para.1 no. 3 CITA exempts the income from equity-like jouissance rights.

The scope of a limited tax liability with respect to income derived from jouissance rights is disputed among academic writers. This dispute originates from the question of which types of jouissance

⁴⁰ See, for example, EBERHARTINGER, Bilanzierung, 149.

⁴¹ See VwGH 09.02.1982, 81/14/0060. See previously VwGH 30.09.1955, 1426/53 and later VwGH 29.04.1981, 3122/79; 16.02.1994, 90/13/0048; 24.02.2000, 96/15/0062.

⁴² See, for instance, VwGH 23.02.1994, 93/15/0163; see further KOHLER, SWK 1994, 365 et seq.; RUPPE, in: BERTEL et al., Unternehmensfinanzierung, 101 (103 et seq.). STOLL, Publikums-(Abschreibungs-)Gesellschaften, 54 et seq. and 66 et seq.

⁴³ In case of redemption; see KIRCHMAYR, in: FS KPMG (1996), 125 (132).

rights are subject to Austrian withholding tax; sec. 98 para.1 no. 5 IITA (the provision establishing the scope of a limited liability to tax with respect to capital income) directly refers to sec. 93 IITA, the provision dealing with withholding tax for capital income. The prevailing opinion⁴⁵ considers only income derived by a non-resident taxpayer from equity-like *jouissance* rights taxable in Austria. These considerations are irrelevant if the financial instrument is held within the investor's business sphere (in a permanent establishment) as, under these circumstances, limited tax liability is established without reference to withholding tax.

It is Austrian tax policy to follow the definition of dividends enshrined in Art. 10 para. 3 OECD-MC which explicitly includes *jouissance* rights.⁴⁶ This is particularly true for the tax treaties with France and Switzerland. The exclusion of debt-claims specifies the broad term of “*jouissance* rights” and excludes debt-like *jouissance* rights from the scope of the dividend article. The final clause of Art.10 para.3 DTC-US might, at first glance, include debt-like *jouissance* rights in the dividend definition. The technical explanations to Art.10, however, clarify that “[t]he definition of dividends ... includes income from arrangements, including debt obligations, that carry the right to participate in profits, or that are determined by reference to profits, *to the extent that such income is characterised as a dividend under the tax law of the source State*” (emphasis added).

d) Participating loan (*Partiarisches Darlehen*), Participating bond (*Gewinnschuldverschreibung*)

Capital which has been raised by means of participating loans and bonds remains debt capital under Austrian income tax law. Consequently, the remuneration paid by the issuer is deductible under sec.4 para.4 IITA; the investor is taxable on these payments according to secs.21 to 23 or 27 IITA. It is an Austrian peculiarity that investors subject to limited tax liability in Austria are not taxable with their income derived from Austrian participating loans or bonds if they are held outside the

⁴⁴ See EBERHARTINGER, *Bilanzierung*, 155 et seq., KIRCHMAYR, in: FS KPMG (1996), 125 (131 et seq.); KIRCHMAYR, *ÖStZ* 1997, 292 (294).

⁴⁵ BAUER, *ÖStZ* 1994, 238 et seq.; KIRCHMAYR, in: FS KPMG (1996), 125 (140 et seq.).

⁴⁶ See LANG, *Hybride Finanzierungen*, 173; HEINRICH, in: IFA, CDFI LXXXVa, 135 (160); HEINRICH, *ÖStZ* 2000, 274 (277).

business sphere (unless they are secured by domestic real estate or domestically registered ships; sec. 98 para.1 no. 5.b IITA).

Among the tax treaties scrutinised, the treaty with Germany is the only one explicitly dealing with participating loans and bonds. Unless the specific clause of Art.10 para.3 DTC-Germany applies, income from participating loans and bonds is covered by the interest article (Art. 11 para. 1 DTC-Germany); the source country, notably, enjoys an unlimited right to tax (Art. 11 para. 2 DTC-Germany). While Austria, as a source country, does not tax non-residents on income derived from participating loans and bonds under domestic law, this provision seems to function to the detriment of Austria.⁴⁷ In cross-border situations involving France, the UK or Switzerland, income from participating loans and bonds is covered by the interest article.⁴⁸ With respect to the United States and similar to the situation regarding debt-like *jouissance* rights, the technical explanations to Art.10 DTC-US exclude income from Austrian bonds participating in profits from the dividend definition; rather, such income falls under the interest article.

4. Conclusion

Austrian corporate and accounting law, on the one hand, and income tax law, on the other hand, maintain essentially different regimes as to the classification of capital as debt or equity. Merely the basic forms of debt and equity enjoy parallel assignment. As soon as a financial instrument can be referred to as being hybrid in whichever respect, the criteria established in each of the legal frameworks must be applied independently. Hence, hybrid financial instruments may be categorised as debt under one regime while treated as equity in another. This divergence primarily originates from the different aims underlying corporate, accounting and income tax law. For corporate and accounting purposes, insolvency risk and business risk aspects are very important. The legal position of the investor compared to a partner or shareholder determines the assignment to debt or equity. The classification in Austrian income tax law basically depends on whether or not the investor participates in the enterprise's profits, latent gains and goodwill. This is particularly obvious in the case of silent

⁴⁷ HEINRICH, in: Lang/Jirousek, FS Loukota (2005), 155 (167).

⁴⁸ See also LANG, *Hybride Finanzierungen*, 181.

partnerships where such participation is treated in the same way as an ordinary partnership. The case of *jouissance* rights is, in principle, classified according to the same criteria. Classification of hybrid financial instruments under Austrian tax treaties follows, to a large extent, an autonomous interpretation.

II. France

1. Introduction

In France, corporate finance has undergone profound changes due to a regulation of 24 June 2004. Ever since, the French Commercial Code (*Code de Commerce*, CCom) has distinguished between three different types of securities (*valeurs mobilières*) which are subject to different legal treatment: capital shares, bonds, and securities granting the right to acquire a capital share or a bond (*valeurs mobilières composées* – composed securities). In spite of these clear distinctions, defined boundaries between debt and equity are difficult to determine due to the fact that hybrids have become more and more common. In particular, the implementation of the so-called *titres super-subordonnés* in 2003, a type of security subordinated to all other debt claims in the event of bankruptcy, converged debt towards equity, whereas the creation of the versatile *actions de préférence* in 2004 modelled on the Anglo-American “*preferred shares*” gives corporations the opportunity to create debt-like capital shares.⁴⁹ Different hybrid instruments characterised mainly by subordination and a stronger capital tie-up than ordinary debt titles already existed before these provisions were enacted.⁵⁰ The 2003 and 2004 provisions, however, give rise to legal issues under tax law not entirely solved yet.

2. Private Law

The position of an equity investor deviates in various aspects from the position of a creditor. Equity is characterised by the *affectio societatis*, the intention of the shareholders or partners to cooperate on equal terms in the pursuit of their common interest.⁵¹ They participate in the company’s profits as well as in its losses and, in the case of liquidation, participate in the remaining assets; the creditor

⁴⁹ See Baudry, *Les actions de préférence*, 17.

⁵⁰ Couret, *La Semaine Juridique*, Edition Entreprises, no. 9 (1990), 143 (144).

⁵¹ See Art. 1832, 1833 *Code Civil*.

is interested in the profits of the business he has invested in only to the extent of his default risk. French commentators find an essential difference between debt and equity in the priority of claims and in the conditions of repayment: Capital shares are only reimbursed in special cases (e.g. capital reduction, liquidation) and after settlement of all other claims whereas debt claims generally are satisfied in due course while the business still is in operation. Primarily, the creditor considers a debt claim a pecuniary claim whereas capital shares are characterised by uncertainty and rather compensated by stronger managing and information rights.⁵²

a) Traditional instruments of equity and debt

Various pecuniary claims are attached to stock (*action*): the cash dividend right, the subscription right⁵³ and the right to be refunded for the capital contribution and to participate in the remaining assets after liquidation.⁵⁴ The shareholder participates in the company's management by attending shareholders' meetings and by exercising his voting right.⁵⁵ Furthermore, the *Code de Commerce* grants him various information and interrogation rights in order to enable him to make proper decisions.⁵⁶

The right to be refunded for his capital contribution can be excluded because of premature reimbursement (*amortissement*).⁵⁷ In this case the shareholder also loses, if originally granted, the right to receive the "first dividend" (which consists in a percentage of the share's par value, see Art. 232-16 CCom) but retains all other rights (information or managing rights, cash dividend right, participation in liquidation profits). After *amortissement*, the share is called *action de jouissance* (jouissance share).

As distinct from these regular capital shares, the bond (*obligation*), a security issued for long-term financing, is a classical debt instrument.⁵⁸ A bond creditor receives fixed or variable interest which may be calculated by reference to the debtor's profits (*obligation participante*). As opposed to a regular bank loan, bonds entitle their holder to some managing and information rights. The holders of identical bonds are united in a group (*masse*) whose representatives may attend shareholders'

⁵² Ohl, *Valeurs mobilières*, September 2005, *Rép. sociétés Dalloz*, 18 et seq.

⁵³ Art. L. 225-132 CCom.

⁵⁴ Art. L. 237-29 CCom.

⁵⁵ Art. L. 225-96 et seqq. CCom.

⁵⁶ Art. L. 225-115 et seqq., L.225-232 CCom.

⁵⁷ See Art. L. 225-198 et seqq. CCom.

⁵⁸ See Art. L. 228-38 et seqq. CCom.

meetings but are not allowed to vote.⁵⁹ Furthermore, the representatives - not each bond holder personally - are entitled to receive the same business information as the shareholders.⁶⁰ The bond holders have to be consulted in a special meeting before certain important decisions are made (e.g. concerning the entity's legal structure or its object).⁶¹ They cannot veto the decision; however, if they do not approve they may elect repayment of the principal amount before maturity.⁶²

b) Hybrids

The 2004 reform has created a very flexible category of corporation shares called *actions de préférence* (preferred shares); they can be provided with debt-characteristic features in various respects. Art. L. 228-11 CCom states that *actions de préférence* may or may not grant (even restricted) voting rights and privileges of any order. Those privileges are not necessarily restricted on the issuer itself but may also relate to another corporation if one of the companies concerned has an interest exceeding 50 % in the other one.⁶³ If such a privilege consists in a right to receive periodical payments, the classification of these payments as dividends is questionable since the receiver has no interest in the distributing corporation.⁶⁴

Some have argued that the term "*actions de préférence*" indicates that the holder of such share should enjoy overall preferential treatment compared to common stock. In consequence, *actions de préférence* not meeting this criterion should not be considered shares at all; particularly, shares without voting rights would have to be classified as debt if the lack of managing powers was not compensated.⁶⁵ Nevertheless, most French commentators disagree⁶⁶ because the text of the statute can be brought forward against this interpretation: Art. L. 228-33 CCom states that *actions de préférence* can be provided with the same rights as the former *certificats d'investissement* (a type of securities not to be issued after the 2004 reform). The holders of these *certificats d'investissement*

⁵⁹ See Art. L. 228-46 et seqq., Art. L. 228-55 CCom.

⁶⁰ Art. L. 228-55 al. 2 CCom.

⁶¹ Art. L. 228-65 CCom.

⁶² Art. L. 228-72 CCom.

⁶³ Art. L. 228-13 CCom.

⁶⁴ Baudry, *Les actions de préférence*, 39.

⁶⁵ Ohl, *Valeurs mobilières*, September 2005, *Rép. sociétés* Dalloz, 32.

⁶⁶ Moulin, *Le Droit de l'Ingénierie financière*, 39; Moulin, *Petites Affiches* no. 189 (2005), 24 (under I.); Baudry, *Les actions de préférence*, 15.

are not entitled to vote while still having the same rights attached to common stock. Thus, the Commercial Code itself states that the “*préférence*” may simply be a disadvantage for the holder. Not only the potential exclusion of any voting right but also the variety of other conceivable privileges or disadvantages allows the design of *actions de préférence* with characteristics resembling debt. One can imagine shares granting a right to benefit from redemption priority over other shares in the event of bankruptcy as well as the right to receive – in case of sufficient business profits – a constant dividend or cumulated dividends if no dividend has been distributed the previous year. However, some legal provisions are mandatory and may therefore not be waived by creating special *actions de préférence*; this particularly holds true as to the existence and approval of distributable profits as a condition for the distribution of dividends.⁶⁷ Thus, even though the position of a shareholder owning an *action de préférence* can be very similar to the position of a simple creditor, there are necessarily some differences, particularly the dependency of the compensation received by the shareholder on the corporation’s profits. Consequently, the Commercial Code classifies *actions de préférence* as capital shares and therefore as equity.⁶⁸

The 2004 reform has also implemented a new category of securities, the so-called *valeurs mobilières composées* (composed securities) which comprise the right to acquire a capital share or a bond (e.g. convertible or exchangeable bonds).⁶⁹ These securities previously subject to different regulations now have a common legal framework, especially with respect to their holders’ protection. Holders of securities granting a right to acquire (only) a bond do not enjoy special statutory protection while holders of securities comprising a right to acquire a capital share have certain managing and information rights.⁷⁰ Holders of identical securities are, just like bond holders, united in a group (*masse*) and called to special meetings. They are entitled to receive the same business information as ordinary shareholders; however, if the right to acquire a capital share is connected to a bond (e.g. convertible or exchangeable bonds), only the group’s representatives may exercise the information rights. The representatives have the right to attend shareholders’ meetings. Furthermore, some measures affecting the position of the security holders may only be taken with their consent if they are not already provided in the terms and conditions of issuance, such as a change of

⁶⁷ See Art. L. 232-12 CCom.

⁶⁸ See Art. L. 225-127 CCom; Ohl, *Valeurs mobilières*, September 2005, *Rép. sociétés Dalloz*, 9.

⁶⁹ Art. L. 228-91 et seqq. CCom.

⁷⁰ See Art. L. 228-98 et seqq. CCom.

the entity's legal structure or object or an amendment of the conditions of profit distribution. Other decisions have to be combined with certain measures aiming at the protection of the security holders' interests, such as a special subscription period.

Some other hybrids under French law are characterised mainly by subordination in the event of bankruptcy.

Art. L. 228-36 CCom states that certain companies, particularly companies working in the public sector, can issue the so-called *titres participatifs*. This financial instrument was implemented in 1983 to assure that the government could alleviate the financial burdens of the public sector while at the same time avoiding the danger of being criticised for excessive privatisation. The new financial instrument was therefore intended to combine elements of equity in terms of risk-structure and elements of debt in terms of managing powers. On the one hand, *titres participatifs* are only reimbursable in liquidation if the company does not choose premature redemption. They resemble equity also in terms of compensation: Interest consists of a fixed and a variable rate depending on the company's activity (e.g. its profits or its sales). Furthermore, *titres participatifs* grant a right to information identical to the one attached to common stock.⁷¹ On the other hand, their holders are united in a group (*masse*) which is basically subject to the same legal provisions as the bond holders' group.⁷² Therefore, only its representatives may attend shareholders' meetings and they are not entitled to vote.

Another financial instrument only available to certain companies is the *prêt participatif*. According to Art. L. 313-13 *Code monétaire et financier* the government, banks and some other companies may grant this kind of loan to craft industries, industrial enterprises or commercial businesses. In liquidation, the lender is repaid only after full satisfaction of all other creditors with the exception of those holding a *titre participatif* or a *titre super-subordonné* (see below). The interest borne by *prêts participatifs* is usually fixed but may be increased by a variable portion calculated on the businesses profits. On the balance sheet, *prêts participatifs* have to be accounted for separately;

⁷¹ Art. L. 228-37 al. 5 CCom; see Ohl, *Valeurs mobilières*, September 2005, *Rép. sociétés Dalloz*, 39.

⁷² *Lamy Sociétés Commerciales* 2007, mn 4729.

financial analysts consider them equity,⁷³ though they are an instrument of debt from a statutory point of view.⁷⁴

Finally, all public limited companies (*sociétés anonymes*) may issue so-called *titres subordonnés*, securities subordinated to other claims in the event of bankruptcy.⁷⁵ They are created by integrating a subordination clause in the terms and conditions of an issuance of (simple or composed) bonds. Different types of *titres subordonnés* may also be subject to a particular order of priority; they may bear fixed or variable interest.⁷⁶ Since 2003, subordination clauses may also assign priority to the above-mentioned *titres* and *prêts participatifs* over newly issued bonds which was not possible in prior years due to a mandatory provision concerning the subordination of those two financial instruments. The 2003 provision sought to enable companies to improve their equity ratio particularly with respect to the legal provisions for credit institutions (Basel II) by creating a financial instrument between debt and equity.⁷⁷ Securities subject to a subordination clause also concerning *titres* and *prêts participatifs* are called *titres super-subordonnés*. They can be very similar to equity if the terms of issuance provide for three additional conditions beside the subordination clause: The investors agree that the capital is tied up indeterminably within the company without forfeiture clause; the payment of interest may be interrupted if no distributable profits are realised, and the capital may serve to cover the corporation's losses. In this case, *titres super-subordonnés* are functionally quite similar to certain *actions de préférence* and can be classified as equity in the consolidated accounts under IFRS.⁷⁸ From the perspective of civil law they nonetheless qualify as debt.⁷⁹ Consequently, their holders are subject to the same legal framework as common bond holders. However, some argue that due to the fact that the risk run by the holder of a *titre super-subordonné* equals

⁷³ Bali, Petites Affiches no. 39 (2009), 8 (under I.A.2.)

⁷⁴ Mémento pratique Francis Lefebvre Sociétés Commerciales 2007, mn 25275; Droit & Patrimoine 2004, no. 128 (under I.A.).

⁷⁵ See Art. L. 228-97 CCom.

⁷⁶ Lamy Sociétés Commerciales 2007, mn 4734.

⁷⁷ Moulin, Le Droit de l'Ingénierie financière, 108; Ohl, Valeurs mobilières, September 2005, Rép. sociétés Dalloz, 40; Droit & Patrimoine 2004, no. 128 (under II.A.); Lagarrigue, Revue de Droit des Affaires Internationales 2005, 540 (541).

⁷⁸ Lagarrigue, Revue de Droit des Affaires Internationales 2005, 540 (545).

⁷⁹ Galland, Bulletin Joly Sociétés 2006, 1111 (under I.A.2.a.); Vernimmen, Finance d'entreprise, 7th edition 2009, 620; Lagarrigue, Revue de Droit des Affaires Internationales 2005, 540 (545); Nizard, Revue de Droit Bancaire et Financier 2006, 47; a dissenting opinion may be found in Droit & Patrimoine 2004, Nr. 128 (under II.A.).

more or less the shareholder's risk they should be granted the same information rights as shareholders.⁸⁰

2. Domestic taxation

a) Taxation of debt and equity

In France, individuals are subject to the national income tax (*impôt sur le revenu* – IR) with their personal and business income. The same rules apply to the income of business partners of a partnership with unlimited liability. From the point of view of French tax law the partnership is transparent, as far as partners with unlimited liability are concerned (see Art. 8 French Tax Code - *Code Général des Impôts*, CGI). Profits are determined on the partnership's level but taxed *pro rata* as income of the partners, regardless whether profit distributions have taken place or not. In contrast, corporations are considered separate legal entities and are subject to corporate tax (*impôt sur les sociétés* – IS, see Art. 206-1 CGI). The *société en commandite simple*, a limited partnership comprising partners with limited and unlimited liability, is subject to two different tax regimes: It is transparent for partners with unlimited liability and nontransparent for partners with limited liability, i.e. to that extent the company as such is subject to corporate tax. Other partnerships may opt for corporate tax.

Corporations may not deduct dividends paid to their shareholders as consideration for the provision of equity. Dividends distributed to individuals or “transparent” partnerships are classified as capital income (*revenus mobilières*) and subject to French income tax. Until 2004, the recipients of dividends received a tax credit (*avoir fiscal*) to the amount of half of the distributed dividends (corresponding to the amount of corporate tax paid by the company at a rate of 33 1/3 %) in order to avoid double taxation.⁸¹ Since 2005, dividends are partially exempted from tax: Only 60 % of the profits distributed to an individual resident in France are subject to income tax.⁸² Moreover, individuals benefit from an annual allowance of 1.525,- € (3.050,- € for married couples)⁸³ and receive

⁸⁰ Galland, Bulletin Joly Sociétés 2006, 1111 (under II.B.1.).

⁸¹ Lamy fiscal 2009, mn 5537; Bali, Petites Affiches no. 39 (2009), 8.

⁸² Art. 158-3-2 CGI.

⁸³ Art. 158-3-5 CGI.

a tax credit of 50 % of the dividends received, though limited to a maximum of 115,- € for individuals and 230,- € for married couples.⁸⁴ It should be noted that dividends are not only subject to income tax but also to important social security taxes: In 2009, these social security taxes amount to 12,1 % of the taxable income. With respect to the social security taxes none of the above-mentioned tax privileges apply. Therefore, regarding the overall burden of charges, they play an important role. As an alternative, since 1 January 2008, individuals receiving dividends can opt for an 18 % flat tax (*prélèvement forfaitaire libératoire*, Art. 117 *quater* CGI).⁸⁵ However, this flat tax compensates only for income tax; in addition, social security taxes have to be paid.

If equity is provided by a corporation, dividends are classified as regular business profits subject to corporate tax at the regular rate of 33 1/3 %. However, they may be partly exonerated due to a special tax regime provided for affiliated groups (*régime des sociétés mère et filiales*, Art. 145 CGI). If the dividend receiving corporation holds more than 5 % of the shares and voting rights of the subsidiary for a period of more than two years, the dividends may be deducted from the holding corporation's profits except for an amount of 5 %. This amount is intended to compensate the assumed charges related to the shares which are, due to the tax exemption, not deductible any more, Art. 216-I CGI.

Interest paid on debt related to a business may be deducted from the corporation's or individual's profits as business expenses. Some exemptions apply to loans granted by company insiders (*comptes courants d'associés*). The investor has to include the interest in his annual tax return. It is subject to his regular income respectively corporate tax rate. Alternatively, individuals may, as for most capital income, opt for the application of the 18 % flat tax. In addition to tax individuals have to pay social security taxes of 12, 1 %.

b) Taxation of hybrids

The income derived from *actions de préférence* is, basically, subject to the same tax treatment as dividends paid on regular shares. The issuer may not deduct payments from his taxable profits, the investor may benefit from the above-mentioned tax privileges for dividends.⁸⁶ However, some spe-

⁸⁴ Art. 200 *septies* CGI.

⁸⁵ Vgl. Instr. 1er août 2008 (BOI 5 I-5-08), Droit fiscal no. 37, 11 September 2008, instr. 13949.

⁸⁶ Lagarrigue, *Revue de Droit des Affaires Internationales* 2005, 540 (547).

cial types of *actions de préférence* are subject to doubts, particularly with respect to the affiliated corporations' tax regime. Until 2006, there was a discussion about the requirement of more than 5 % of voting power in the subsidiary concerning shares excluded from voting; in 2006, new legal provisions have specified that even dividends distributed on non-voting shares may benefit from the tax privilege if the taxpayer meets the overall minimum voting requirement.⁸⁷ Nonetheless, this regulation did not answer all questions raised by French commentators. One may, for example, ask if a restricted voting right (e.g. limited to ordinary or extraordinary shareholders' meetings) still meets the 5 % voting power requirement set up in Art. 145 CGI; some answer in the negative pointing out that French courts do not consider beneficial ownership in shares sufficient for the application of the favourable tax regime because a beneficiary only may vote under certain circumstances.⁸⁸ The applicability of the affiliated corporations' tax regime is also called into question if the holder of an *action de préférence* is entitled to receive a fixed payment or receives his dividend regardless of whether a resolution about profit distribution has already been adopted at the shareholders' meeting.⁸⁹ These doubts are based on a decision of the highest fiscal court in France, the *Conseil d'Etat*, concerning the characteristics of dividends: The court has ruled that dividends are payments made according to a regular shareholders' resolution out of the corporation's current or accumulated profits equally to all shareholders.⁹⁰ Finally, payments from a subsidiary or a parent on *actions de préférence* issued by an affiliated corporation in application of Art. L. 228-13 CCom are difficult to classify for fiscal purposes: Can they be regarded as dividends although the payee has no share in the distributing corporation?⁹¹ It appears that, as of today, no definitive answers have been found.

Composed securities (*valeurs mobilières composées*) based on a bond but convertible or exchangeable into shares are treated as debt for tax purposes until the conversion or exchange takes place; the interest paid on them is deductible from the issuer's profits and, for the investor, subject to corporate or income tax.⁹² Payments made after conversion or exchange are taxed as regular dividends.

⁸⁷ See Art. 145-6 b *ter* CGI.

⁸⁸ Lagarrigue, *Revue de Droit des Affaires Internationales* 2005, 540 (549).

⁸⁹ Ohl, *Valeurs mobilières*, September 2005, *Rép. sociétés Dalloz*, 28.

⁹⁰ CE 8 juillet 1992, req. no. 88.734, *Gardet, Rec. CE*, 284.

⁹¹ Vgl. Gillig, *Droit des sociétés* Nr. 5, Mai 2007, alerte 21 (under 2.A.).

⁹² *Théorie et pratique des obligations convertibles en actions et des produits assimilés*, 269 et seq.

The different subordinated securities mentioned above are all taxed as debt. Interest paid on *titres participatifs* or *prêts participatifs* is therefore deductible even if contingent on the debtor's profits.⁹³ French authorities also characterise *titres super-subordonnés*, though equity-flavoured, as debt.⁹⁴ This fiscal treatment was politically intended: During legislation procedure, the French minister of economy and finance expressively stressed that the new financial instrument should be considered debt in accounting as well as in tax law.⁹⁵ However, French commentators observe that tax authorities could possibly challenge this classification if, given the terms and conditions of issuance, a certain instrument provides for extensive equity characteristics.⁹⁶

3. International Taxation

a) Unilateral French law

French residents are subject to French taxation on their worldwide income.⁹⁷ If such a person receives interest or dividends from a foreign corporation, this income is subject to French income tax as well as to the 12, 1 % social security taxes due on capital income. In the case of dividends, the investor may choose between the two taxation schemes for domestic dividend distribution described above (partial exemption or flat tax), provided that the distributing corporation is resident in a European Member State or in a country that has entered a tax treaty with France meeting certain requirements. In the case of interest on debt, the individual may equally opt for the flat tax if the debtor is resident in one of those countries.⁹⁸

Unlike individuals who are taxable with their worldwide income, corporations are taxed according to the principle of territoriality. Therefore, only profits earned in France or attributed to France by a tax treaty are subject to corporate tax.⁹⁹ Dividends received by a French corporation from a foreign

⁹³ Boizard, Martine/Raimbourg, Philippe, *Ingénierie Financière Fiscale et Juridique*, 2006/2007, 427 (*titres participatifs*); Galland, *Bulletin Joly Sociétés* 2006, 1111 (under I.A.2.b. and II.B.3.: *prêts participatifs*).

⁹⁴ Boizard, Martine/Raimbourg, Philippe, *Ingénierie Financière Fiscale et Juridique*, 2006/2007, 321.

⁹⁵ JOAN, séance du 30 avril 2003, 3364, as cited in Lagarrigue, *Revue de Droit des Affaires Internationales* 2005, 540 (545).

⁹⁶ Galland, *Bulletin Joly Sociétés* 2006, 1111 (under I.B.3.).

⁹⁷ Art. 4 A CGI.

⁹⁸ Art. 125 A-I CGI, see *Mémento pratique Francis Lefebvre Fiscal* 2008, mn 2350.

⁹⁹ Art. 209-I CGI.

subsidiary are exempt from tax but for 5 % if the tax regime for affiliated groups applies.¹⁰⁰ Interest paid by a foreign company to a French corporation and dividends not subject to tax privileges are taxed at the regular corporate tax rate.

Non-residents are only subject to tax on income from French sources. In particular, Art. 164 B CGI provides that payments on French securities are income from French sources. Income is subject to the regular progressive income tax rate only if no tax has been withheld at source.¹⁰¹

If a non-resident individual receives dividends or other distributions from a French corporation, these payments are subject to a 25 % withholding tax. The same withholding tax applies to dividends distributed to foreign corporations,¹⁰² though the French Tax Code provides for various exceptions. In particular, tax privileges have been created for distributions to a parent corporation resident in a European Member State.¹⁰³

Interest paid on debt by French corporations to a foreign investor is generally subject to an 18 % flat tax, Art. 125 A-III CGI, though not to social security taxes. But there are various exemptions from this withholding tax, particularly concerning interest on bonds¹⁰⁴ and payments from a French subsidiary to a European parent corporation meeting the minimum shareholding requirement of Art. 119 *ter* CGI.

As a general rule the taxation of hybrids held by foreign investors follows the rules described above for domestic investments. Therefore, the proper tax treatment depends on the characterisation of the financial instrument as either debt or equity.¹⁰⁵ Composed securities providing for a conversion or exchange from debt to equity are subject to different tax regimes before and after conversion or exchange.

b) Double Tax Conventions

As to the right to tax debt or equity, most French tax conventions are based on the OECD model income tax convention (OECD model). However, in most cases, they exclude the right to withhold

¹⁰⁰ Mémento pratique Francis Lefebvre Fiscal 2008, mn 3677.

¹⁰¹ Lamy fiscal 2009, mn 4373.

¹⁰² See Art. 119 *bis*-2, Art. 187-1 CGI; Mémento pratique Francis Lefebvre Fiscal 2008, mn 2192.

¹⁰³ See Art. 119 *ter* CGI; Droit fiscal no. 36, 6 September 2007, instr. 13757.

¹⁰⁴ See Lamy Fiscal 2009, mn 5387.

¹⁰⁵ Zeller, *Revue de Droit bancaire et financier* no. 3, may 2008, mn 23 et seqq.

tax on interest paid to foreign investors. In contrast, the France/U.S. tax treaty provides for the right of the source state to tax interest contingent on the debtor's profits at a maximum rate of 15 % (the same rate applicable to dividends). With respect to dividends, the conventions with Germany, Switzerland, Austria, the United Kingdom and the U.S. all allow a withholding tax at a maximum rate of 15 % on portfolio dividends, whereas dividends from subsidiaries are subject to a lower maximum tax rate or may not be taxed at all by the source state.

In distinguishing dividends from interest, most French tax treaties are based on the OECD model. It appears that France is less concerned with the classification of payments contingent on the debtor's profits as interest and, as a consequence, in foregoing the right to tax as the source state. Interest paid on *titres* or *prêts participatifs* or on *obligations participantes* contingent on the debtor's profits or sales is therefore exempt from withholding tax.

Only the France/Germany and the France/U.S. tax treaties contain special provisions. The France/German convention unilaterally reserves taxing jurisdiction for some profit-related hybrids in Art. 9-6 b: In Germany, income deriving from silent partnerships (Stille Gesellschaften), participating loans (Partiarische Darlehen), participating bonds (Gewinnobligationen) or similar instruments entitling the investor to receive contingent payments qualifies as dividends for treaty purposes. In contrast, France does not re-characterise similar hybrids. Thus, from the French point of view, payments on *titres* or *prêts participatifs* or on *obligations participantes* are still exempt from withholding tax, having to be classified as interest under the tax treaty. The France/U.S. tax treaty bilaterally reserves taxing jurisdiction of the source state with respect to contingent payments. According to Art. 10-5 a) contingent payments on indebtedness are subject to the dividend article to the extent so characterised under the laws of the source state. Furthermore, Art. 11-2 entitles the source state to a withholding tax at a maximum rate of 15 % concerning interest contingent on the debtor's profits. In the remaining conventions, the exclusion of the source state's right to tax interest is only limited by the arm's-length-principle applicable to related-party interest, as stipulated in the OECD model.

III. Germany

1. Commercial and Corporate Law

a) General Aspects of Debt and Equity

Under German commercial and corporate law debt and equity differ in various fundamental aspects. First of all, an equity investor acquires an actual share in the company or partnership.¹⁰⁶ By contrast, a debt investor only receives a contractual claim against the debtor.¹⁰⁷ Second, the legal transaction establishing a share – the company or partnership agreement – always refers to a purpose which all partners or shareholders pursue in common.¹⁰⁸ The contract of loan, upon which a debt claim is based, is characterised by opposing interests of debtor and creditor. Thirdly, a shareholder or partner shares in the successes and failures of the enterprise. On the one hand he participates in the profits of the enterprise as a reward for his capital investment. In case of liquidation he receives a share in the latent gains¹⁰⁹. On the other hand he has to bear his stake in the losses of the enterprise. Thus, he participates in all opportunities and risks of the enterprise.¹¹⁰ By contrast, a creditor receives a fixed interest for his capital commitment irrespective of the debtor's profits. At the end of the term, he obtains the nominal value of his claim and does not participate in the latent gains of the company. Therefore, he neither benefits from the opportunities nor shares the risks (except insolvency) of the debtor's enterprise. Fourth, unlike a creditor, a shareholder or partner has at least indirect managing powers and is entitled to obtain information.

b) Non-Voting Preference Shares (*Stimmrechtslose Vorzugsaktien*)

The provisions of the AktG¹¹¹ are largely mandatory. Therefore, it is generally not possible to shape shareholder rights by party autonomy. The only statutory exception refers to preference shares (*Vorzugsaktien*). Formally, a preference share is still a share, however the preferred shareholders' pecuniary entitlements, as well as the managerial and control rights can be formed within the framework of sec. 139 et seq. AktG. A preference shareholder has to be given a preferential right to

¹⁰⁶ K. SCHMIDT, *Gesellschaftsrecht*, 4th edition 2002, § 19 I. 3. a), p. 549.

¹⁰⁷ The contract will usually be a loan governed by sec. 488 et seq. BGB (*Bürgerliches Gesetzbuch* = Civil Code).

¹⁰⁸ K. SCHMIDT (fn. 106), § 4 I. 2. a), p. 59.

¹⁰⁹ *Stille Reserven* (latent gains) result from the non-realised difference between book value and market value of the entire enterprise or a single asset.

¹¹⁰ EILERS, in: Eilers/Rödding/Schmalenbach (eds.), *Unternehmensfinanzierung*, 2007, part A para. 2.

the profit. The amount needs to be objectively determinable.¹¹² However, sec. 57 (3) AktG stipulates that the corporation must make a sufficient profit in order for a dividend to be payable.¹¹³ A preference shareholder can but does not need to participate in any profit in excess of the preference.¹¹⁴ His right to participate in the latent gains however cannot be waived. As the term implies, a preference shareholder can be excluded from voting, while his entitlement to contest any resolution of the shareholders' meeting and his right to information cannot be contractually waived.¹¹⁵

c) Limited partnership (*Kommanditgesellschaft*)

Unlike stock corporation law, the law of partnerships is largely non-mandatory. Therefore, limited partnerships (*Kommanditgesellschaften*) offer a wide opportunity to raise hybrid capital. A limited partner (*Kommanditist*), while formally still a partner, possesses diminished rights in comparison to a general partner by virtue of sec. 164 et seq. HGB.¹¹⁶ What is more, his rights can be abrogated further by the partnership agreement. According to the default provisions of the law, he participates in the profits and losses as well as in the latent gains of the partnership¹¹⁷ in case of dissolution or his leaving the partnership before that time. Except for his limited liability, all of these rights and duties can be waived¹¹⁸; e.g., it can be agreed that such partner receives merely a fixed interest rate and is entitled to redeem his capital investment irrespective of any profits, losses or latent gains. Like a creditor, such a limited partner's exposure to the fortunes of the enterprise, is very limited, although he bears slightly more risk in the sense that his liability cannot be waived. A limited partner does not participate in the management. The general partner only needs his assent in case of exceptional dealings.¹¹⁹

¹¹¹ *Aktiengesetz* = Stock Corporation Act.

¹¹² HÜFFER, *Aktiengesetz*, 8th edition 2008, § 139 para. 7.

¹¹³ HÜFFER (fn. 112), § 139 para. 2.

¹¹⁴ HÜFFER (fn. 112), § 139 para. 8.

¹¹⁵ SEMLER, in: Hoffmann-Becking (ed.), *Münchener Handbuch des Gesellschaftsrechts*, vol. 4, 3rd edition 2007, § 38 para. 24.

¹¹⁶ *Handelsgesetzbuch* = Commercial Code.

¹¹⁷ *Bundesgerichtshof* (BGH = Federal Supreme Court), *Neue Juristische Wochenschrift* (NJW) 1985, p. 192 (193); HOPT, in: Baumbach/Hopt (eds.), *Handelsgesetzbuch*, 33rd edition 2008, § 131 para. 49; PIEHLER/SCHULTE, in: Hoffmann-Becking (ed.), *Münchener Handbuch des Gesellschaftsrechts*, vol. 2, 3rd edition 2007, § 37 para. 22.

¹¹⁸ V. FALKENHAUSEN/H. SCHNEIDER, in: Hoffmann-Becking (fn. 117), § 23 para. 22, 24, 25, 44.

¹¹⁹ GRUNEWALD, *Gesellschaftsrecht*, 7th edition 2008, 1. C. para. 15.

d) Silent partnership (*Stille Gesellschaft*)

Another instrument used to raise hybrid capital in Germany is the silent partnership. The term partnership is misleading in that a silent partnership is not a legally established association but rather a set of contractual obligations that exist between the partners. The entrepreneur, who can be a corporation, partnership, or an individual, owns the property and manages the enterprise on his own. The silent partner's claims and obligations are merely contractual.¹²⁰ The partnership agreement differs from other contracts such as loan contracts by a common purpose the partners agree to pursue and advance together.¹²¹ According to sec. 230 et seq. HGB, a silent partner participates in the profits and losses but not in the latent gain – his contribution will be paid back at nominal value.

The silent partner's right to a share in the profit cannot be waived entirely although the means by which this share is calculated may be modified by the partnership agreement (sec. 231 (2) HGB). The parties can arrange for the silent partner to receive anything from a percentage share of the profit to a fixed interest, which will only be paid in case of sufficient profit. Furthermore, it is possible to pay part but not all of the consideration for the capital contribution irrespective of a profit.¹²²

The silent partner's consideration does not have to be linked to the profit as shown in the annual accounts. The annual net income, the dividends or even the profits of a single branch establishment can serve as possible alternative points of reference.¹²³ However, a participation based on turnover is not deemed to be a participation in the profits, as required by sec. 231 HGB.¹²⁴ The duty to bear losses can be contractually waived (sec. 231 (2) HGB). The rights of the silent partner upon dissolu-

¹²⁰ *Reichsgericht* (RG = Supreme Court of the German Reich), Seufferts Archiv vol. 81 (1927), no. 207.

¹²¹ *Entscheidungen des Bundesgerichtshof in Zivilsachen* (BGHZ = Decisions of the Federal Supreme Court in Civil Matters) 126, p. 176 (177 et seq.).

¹²² K. SCHMIDT, in: K. Schmidt (ed.), *Münchener Kommentar zum Handelsgesetzbuch*, 2nd edition 2007, § 230 Rn. 38, 41.

¹²³ Cp. HABERSACK, in: Goette et al. (eds.), *Münchener Kommentar zum Aktiengesetz*, 3rd edition 2008, § 221 para. 95 concerning *jouissance* rights.

¹²⁴ BGH, *Neue Juristische Wochenschrift Rechtsprechungsreport* (NJW-RR) 1988, p. 417; *Bundesfinanzhof* (BFH = Federal Financial Court), *Bundessteuerblatt II* (BStBl. II) 1988, p. 62 et seq., 2001, 359 et seq.; *Finanzgericht Niedersachsen* (FG = Financial Court of Lower Saxony), *Entscheidungen der Finanzgerichte* (EFG) 1997, p. 529 et seq.; BEZ-ZENBERGER/KEUL, in: Hoffmann-Becking (fn. 117), § 72 Rn. 15; SCHÖN, *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (ZGR) 1993, p. 210 (222).

tion of the silent partnership can be extended so that he does not only obtain the nominal value of his investment but also a stake in the latent gains. A silent partner possesses no managing rights except for a right to reject changes of the object of the enterprise.¹²⁵

e) Participating loan (*Partiarisches Darlehen*)

A participating loan is a loan that gives a creditor a share in the profits as consideration for his capital commitment.

It is an atypical loan contract governed by sec. 488 et seq. BGB, which is primarily characterised by the opposing interest of the contracting parties, whereas the partners of a silent partnership pursue a common purpose.¹²⁶ Of course, both parties to a participating loan wish to see the company maximise its profits and therefore have at least one goal in common. However, court decisions distinguish between participating loans where the parties are bonded only by the common interest to make a high profit and a silent partnership where the partners pursue the common purpose of undertaking a business together.¹²⁷ This distinction can be very complex and will depend on the parties' intent, as ascertained based on an analysis of all circumstances of the individual case. Circumstances that will always lead to a characterisation as a silent partnership are shared participation in losses¹²⁸ or latent gains¹²⁹ as well as shared participation in the management of the business. The express granting of rights to obtain information is evidence for a silent partnership, whereas the express waiver of those rights is evidential for a participating loan. Where a party's contractual rights are non-transferable, there is no right to redeem one's interest in the normal course, or the repayment obligation is not secured, courts are likely to construe the arrangement as a silent partnership.

¹²⁵ GRUNEWALD (fn. 119), I. D. Rn. 21; K. SCHMIDT, in: K. Schmidt (ed.), *Münchener Kommentar zum Handelsgesetzbuch*, 2nd edition 2007, § 230 para.178.

¹²⁶ SPRAU, in: Palandt, *Bürgerliches Gesetzbuch*, 69th edition 2009, § 705 para. 9.

¹²⁷ BGH NJW 1990, p. 573 (574).

¹²⁸ K. SCHMIDT (fn. 125), § 230 para. 60; VON GERKAN/MOCK, in: Röhrich/v. Westphalen (eds.), *Handelsgesetzbuch*, 3rd edition 2008, § 230 para. 61; SCHÖN, ZGR 1993, p. 210 (222).

¹²⁹ K. SCHMIDT (fn. 125), § 230 Rn. 60; VON GERKAN/MOCK (fn. 128), § 230 para. 61.

Due to the principle of contractual freedom, the right to participate in the profits can be shaped freely by the contract. In contrast to the situation of a silent partnership, the turnover can be a point of reference without changing the classification of the contract as a contract of loan.¹³⁰ The investor does not have any managing powers, but only an implied entitlement to obtain the information he needs in order to assess the amount of his claim.¹³¹

f) **Jouissance Right (Genussrecht)**

Very popular financial instruments are *jouissance* rights. Although several provisions mention *jouissance* rights, they are not statutorily defined in a general way.¹³² For the purpose of sec. 221 (4) AktG *jouissance* rights are defined as obligations that give the investor at least one pecuniary right comparable to the pecuniary rights of a shareholder or, alternatively, a right curtailing the shareholder's pecuniary rights in any other way.¹³³

The bearer of the *jouissance* right does not hold a share in the corporation. He only has a contractual claim.¹³⁴ Just as participating loans, *jouissance* rights differ from silent partnerships because the parties are not bound by a joint purpose. The distinction is even more complex since *jouissance* rights, unlike participating loans, can involve a participation in losses and latent gains. When it comes to characterising the arrangement, courts tend to rely on the wording of the parties' agreement.¹³⁵

Since there are no provisions regulating the admissible content of *jouissance* rights, the parties are free to shape their content according to their individual requirements. It is possible to create *jouissance* rights that provide for a share in the profits, the turnover, the latent gains, or the losses. The bearer of a *jouissance* right neither has any managing rights nor rights to obtain information.

¹³⁰ Cp. WEIDENKAFF, in: Palandt (fn. 126), § 488 para. 2.

¹³¹ BGH, Wertpapier Mitteilungen (WM) 1959, p. 595; 1968, p. 1245; NJW 1989, p. 225 (226).

¹³² BGHZ 119, p. 305 (309).

¹³³ HÜFFER (fn. 112), § 221 para. 24-25a.

¹³⁴ *Entscheidungen des Reichsgerichtshof in Zivilsachen*(RGZ = Decisions of the Supreme Court of the German Reich in Civil Matters) 83, p. 295 (298); 115, p. 227 (230); BGHZ 119, p. 305 (309); 120, p. 141 (146 f.); 156, p. 38 (43); HÜFFER (fn. 112), § 221 para. 26; HABERSACK (fn. 123), § 221 para. 64.

¹³⁵ BFH BStBl. II 2008, 892 et seq.

2. Tax Law

a) Domestic Tax Treatment of Debt and Equity

Income from a capital investment can be taxed in Germany under three tax acts – income tax, corporation tax and municipal trade tax.

aa) Equity

When equity is invested in a corporation, both the corporation and the investor are taxed. The corporation has to pay corporation and trade tax on its profits. According to sec. 8 (3) KStG¹³⁶ dividends are not deductible and therefore in effect subject to 15.825% corporation tax (including solidarity surcharge) and, depending on the municipality in which the corporation is located, about 15% trade tax.¹³⁷

If the investor is an individual and his shares are privately-held assets, the dividends and other capital gains¹³⁸ are capital income and subject to income tax¹³⁹. The tax on the dividend distribution will be withheld at source at a flat rate of 26.375%. The dividends are not to be included in the annual tax assessment. The average¹⁴⁰ overall tax burden on the income in this case is roughly 50%.

If the shares are business assets, the dividends and other capital gains are re-qualified as trade income. Despite the tax deduction at source, the dividends are included in the annual tax assessment and taxed at the normal progressive tax rate.¹⁴¹ The withholding tax is refunded through a tax credit. To compensate for the corporation and trade tax paid previously by the corporation, 40% of the

¹³⁶ = *Körperschaftsteuergesetz* (Corporation Tax Act).

¹³⁷ The trade tax base is, in principle, linked to the (corporate) income tax base (sec. 7 (1) *GewStG* (*Gewerbsteuergesetz* = Trade Tax Act)).

¹³⁸ Such as gains from sale or redemption in case of liquidation (sec. 20 (1) no 2, (2) *EStG*).

¹³⁹ Sec. 20 (1) no. 1 *EStG* (*Einkommensteuergesetz* = Income Tax Act).

¹⁴⁰ The tax rate of the trade tax differs in the communities.

¹⁴¹ The top marginal income tax rate is 47.475% (including solidarity surcharge).

income is exempted from income tax (*Teileinkünfteverfahren*).¹⁴² Assuming that the income is taxed with the top marginal income tax rate, the average overall tax burden in this case is again roughly 50%.

Partnerships are tax transparent in Germany. Therefore, if a partnership is the capital-raising entity, only the partners pay income or corporation tax on their share in the profit of the partnership. Although the partnership has to pay trade tax, this does not increase the overall tax burden on the income for partners that are not corporations, since a tax credit is given to these partners for the previously paid trade tax. Assuming that the income is subject to the top marginal income tax rate, the overall tax burden on the capital income will therefore be 47.475%.

bb) Debt

Interest paid on debt is deductible. Therefore, the capital-raising entity does not pay income or corporation tax on its payments to the creditor. However, 25% of the paid interest that exceeds 100,000 Euro p.a. is added back to the tax base for trade tax purposes (sec. 8 (1) no 1 GewStG).

If the investor is an individual taxpayer and if the claim is a private asset, both interest payments and capital gains are regarded as taxable capital income (sec.20 (1) No 7, (2) EStG). In principle, there is no deduction at the source and the tax is imposed by assessment. Nevertheless, the interest is not taxed by the normal progressive tax rate but a flat tax rate of 26.375%. Due to the deductibility of interest paid on debt, the overall tax burden on income from debt claims is roughly 30 % and is therefore significantly lower than the tax on equity income. Both the interest payments and the capital gains are re-qualified as trade income and taxed under the normal tax rates of income and corporation tax, if the claim is a business asset or the investor is a corporation. The overall tax burden in this case can be considerably higher.

cc) Preference Shares and Participating Loans

¹⁴² If the investor is a corporation the dividends and other capital gains are exempted from income tax except for 5 % which are deemed to be non-deductible operating expenses (sec. 8b KStG).

Dividends and other capital gains from preference shares are always taxed like income from ordinary shares, whereas a participating loan is always treated as debt¹⁴³.

dd) Limited Partnership

As described above, partnerships are tax transparent. However, not everyone who is formally a partner under commercial law is also “partner” for the purpose of tax law. Sec. 15 (1) no 2 EStG requires that the partner shows the features of a co-entrepreneur (*Mitunternehmer*). In other words, the partner needs to bear commercial risk and to have at least some managerial authority. Since sec. 15 (1) no 2 EStG expressly mentions the limited partnership as a statutory example for a commercial partnership¹⁴⁴, a typical limited partner with the pecuniary entitlement and limited managerial rights stipulated in sec. 164 et seq. HGB is considered to be a co-entrepreneur in this sense.¹⁴⁵

When the pecuniary entitlement of the limited partner is contractually diminished, this qualification may change. Wherever the limited partner does not participate either in the profit, the losses or the latent gains of the enterprise, he does not bear enough commercial risk to be regarded as co-entrepreneur. In this case, the consideration paid to him for his capital contribution is deducted on a pro rata basis from the profits of the other partners and is taxed in his hands as debt income.¹⁴⁶

ee) Silent Partnership

The income of a typical silent partner with the pecuniary and managing powers as provided by sec. 230 et seq. HGB is essentially¹⁴⁷ taxed as debt income.¹⁴⁸ This changes, however, if the rights of the silent partner are expanded to such an extent that he may be considered a co-entrepreneur. This will

¹⁴³ Except that there is a source withholding for participating loans (sec. 43 (1) no. 3 EStG).

¹⁴⁴ HEY, in: Tipke/Lang (eds.), *Steuerrecht*, 19th edition 2008, § 18 para. 38.

¹⁴⁵ *Bundesfinanzhof* (BFH = Federal Fiscal Court), BStBl. II 1981, p. 663 et seq; HEY (fn. 144), § 18 para. 38.

¹⁴⁶ *Großer Senat des Bundesfinanzhofs* (Great Senate of the Federal Fiscal Court), *Bundessteuerblatt* II 1984, p. 751 et. seq.; BFH, *Deutsches Steuerrecht* 2000, p. 193 (194); HAEP, in: Herrmann/Heuer/Raupach (eds.), *Einkommensteuergesetz*, 2005, § 15 para. 372.

¹⁴⁷ The only difference is that there is a source withholding for silent partnership shares.

¹⁴⁸ STUHRMANN, in: Blümich (ed.), *Einkommenssteuergesetz*, 101st sup. 2008, § 15 para. 316.

be the case if the atypical silent partner is entitled to participate not only in the profits but also in the latent gains and has to bear a part of the losses. In this case, he bears commercial risk to such an extent that will outweigh the fact that he has only very limited managing authority.¹⁴⁹ Conversely, an atypical silent partner entitled with comprehensive management authority is regarded as co-entrepreneur, even if he does not participate in latent gains or losses.¹⁵⁰

ff) *Jouissance* Right

The taxation of income from a *jouissance* right is regulated by sec. 8 (3) KStG and sec. 20 (1) no 1 EStG. According to these provisions a *jouissance* right granting a share of the profits and the remaining assets after liquidation (*Liquidationserlös*) is taxed as a stock share.

In order to be characterised as a participation in the profits under this statute, the consideration must be linked to a “net value” like the balance-sheet profit, the profit of a single branch or the dividends paid to shareholders.¹⁵¹ In contrast, a reward tied to the turnover or other gross figures is not deemed to constitute participation in the profits for the purposes of these provisions.¹⁵² A warranted minimum interest payment is possible as long as it is sufficiently lower than the expected profit.¹⁵³

The word *Liquidationserlös* is misleading. Literally, the redemption of one’s capital contribution after the liquidation of the corporation would constitute a participation in the *Liquidationserlös*. The fiscal courts and administration agree that *Liquidationserlös* is not to be understood literally and that it means proportional participation in the latent gains.¹⁵⁴ Furthermore, *Liquidation* is not to be understood according to private law as the formal termination of the corporation but as end of the term of the *jouissance* right. The requirement of *Beteiligung am Liquidationserlös* is met if the

¹⁴⁹ BFH, BStBl. II 1982, p. 59 (60); 1994, p. 635; p. 700 (701). HAEP, in: Herrmann/Heuer/Raupach, Einkommensteuergesetz, 2005, § 15 para. 395.

¹⁵⁰ BFH, BStBl. II 1982, p. 389 (390); GmbH Rundschau 1991, p. 217 (219); p. 337 (339).

¹⁵¹ STEIN, in: Herrmann/Heuer/Raupach, Körperschaftsteuergesetz, 2005, § 8 para. 184; RENGERS, in: Blümich, Körperschaftsteuergesetz, 101st sup. 2008, § 8 para. 202.

¹⁵² STEIN (fn. 151), § 8 para. 184.

¹⁵³ KNOBBE-KEUK, Bilanz- und Unternehmenssteuerrecht, 9th edition 1993, p. 591; GOSCH, Körperschaftsteuergesetz, 2nd edition 2009, § 8 para. 151.

¹⁵⁴ BFH, Der Betriebs Berater (BB) 2005, p. 2446 (2448).

bearer of the *jouissance* right participates in the latent gains after the redemption of the *jouissance* right.¹⁵⁵

As a further requirement, the obligation must be characterisable as *jouissance* right. In particular, it has to be distinguished between *jouissance* rights and silent partnerships. This characterisation can have a significant impact on the overall tax burden since a silent partner is treated as a creditor as long as he does not participate in profits, latent gains *and* losses. By contrast, a *jouissance* right is already treated like stock shares for tax purposes if it entitles one to participate in the profits and latent gains; a participation in losses is not necessary. The fiscal courts and administration follow the private law distinction and require a common purpose of investor and corporation to classify an investment as silent partnership.¹⁵⁶

b) Unilateral German Taxation of Foreign Investors

The income from an investment of a non-resident is only taxed in Germany if it is domestic income (*inländische Einkünfte*) under sec.49 EStG.

aa) Domestic Income – Limited Tax Liability

A general partner's share in the profit is domestic income insofar as the income is attributable to a German permanent establishment.¹⁵⁷ Dividends paid to shareholders including preference shareholders are deemed to be domestic income if the corporation has its statutory seat or principal place of business in Germany.¹⁵⁸ Thus, income from German-sourced equity is usually taxable in Germany. By contrast, interest paid on loans is only domestic income if the loan is secured by domestic real estate.¹⁵⁹

bb) Limited partnership / Silent partnership

¹⁵⁵ STEIN (fn. 151), § 8 para. 187; RENGERS (fn. 151), § 8 para. 203.

¹⁵⁶ BFH, BStBl. II, 2008, p. 852 et seq.

¹⁵⁷ Sec. 49 (1) no. 2 lit. a) EStG.

¹⁵⁸ Sec. 49 (1) no. 5 lit. a) EStG.

A typical limited partner and an atypical silent partner¹⁶⁰ are co-entrepreneurs and receive trade income. Their share in the profits is taxable in Germany insofar as it is attributable to a German permanent establishment.

An atypical limited partner with limited pecuniary rights is treated differently. An atypical limited partner at least participating in the profits is comparable to a silent partner.¹⁶¹ As with the consideration paid to a silent partner¹⁶², his consideration is taxable in Germany if the limited partnership has its statutory seat or principal place of business in Germany. In contrast, an atypical limited partner only receiving a fixed interest irrespective of any profit is comparable to a normal creditor¹⁶³ and receives capital income according to sec. 20 (1) no 7 EStG. His income is only taxable in Germany if the investment is secured with German real estate.¹⁶⁴

cc) Participating loan

Consideration paid to a non-domestic investor for a participating loan is considered domestic income if the debtor's statutory seat or principal place of business is in Germany. In contrast to a silent partnership, consideration for the loan does not need to be linked to a "net value" to be considered a participating loan for the purpose of limited tax liability. According to the *Bundesfinanzhof*, a connection to the turnover of the enterprise is sufficient.¹⁶⁵ This interpretation of the term *partiarisches Darlehen* complies with the objective of sec. 49 (1) no 5 lit. a) EStG. The provision is supposed to ensure the taxability of domestic business income in Germany.¹⁶⁶ Where the consideration is tied to turnovers, there is a risk that such income could be transferred abroad and not taxed in Germany.

dd) Jouissance Rights

¹⁵⁹ Sec. 49 (1) no. 5 lit. c) lit. aa) EStG.

¹⁶⁰ KLEIN, in: Herrmann et al. (fn. 146), § 49 para. 824.

¹⁶¹ BFH, BStBl. II 1981, p. 663 (665); 1996, p. 269 (272).

¹⁶² Sec. 49 (1) no. 5 lit. a), 20 (1) no. 4 EStG.

¹⁶³ BFH, BStBl. II 1996, p. 269 (272).

¹⁶⁴ Sec. 49 (1) no. 5 lit. c) lit. aa) EStG.

¹⁶⁵ BFH, BStBl. II 2001, 67 et. seq.

A *jouissance* right granting a share in the profit and the latent gains (equity-like *jouissance* rights) and other *jouissance* rights (debt-like *jouissance* rights) are taxable in Germany if the creditor has its seat or headquarters in Germany.¹⁶⁷ The latter includes obligations entitling the bearer only to participate in the latent gains but not granting him a part of the profit.

c) Taxation of Foreign Investors under German Double Taxation Treaties

Furthermore, in order to impose taxation on foreign investors' income, Germany needs to be entitled to tax the capital income under the tax treaty with the respective country of residency.

The OECD Model Convention assigns a limited taxation power for dividends as well as interest to the source country. The German tax treaties differ in that the country of residency usually has the exclusive taxation power over interest.¹⁶⁸

Due to the flow-through taxation of partnerships, the general partner's shares in the profit of a partnership are business profits within the scope of Art.7 of the OECD Model Convention. Since German tax treaties usually follow the Model Convention in this respect, the source country is allowed to tax these shares provided they are attributable to a permanent establishment in that country.

aa) Limited Partnership / Silent Partnership

Earnings from a typical silent partnership are not dividends within the scope of Art.10 (3) of the OECD Model Convention.¹⁶⁹ In German tax treaties the definition is usually extended, so that Germany as the source country is entitled to a limited tax deduction at source. An atypical limited part-

¹⁶⁶ *Reichsfinanzhof* (Supreme Fiscal Court of the German Reich), *Steuer und Wissenschaft* 1928, p. 912 (913); 6th Committee of the *Reichstag* (parliament of the German Reich), *Reichstagsdrucksachen* III/1229, p. 2.

¹⁶⁷ For equity-like *jouissance* rights, sec. 49 (1) no. 2 lit. a) EStG; for debt-like *jouissance* rights, GOSCH, in: Kirchhof (ed.), *Einkommensteuergesetz*, 8th edition 2008, § 49 para. 129.

¹⁶⁸ PÖLLATH/LOBECK, in: Vogel/Lehner (eds.), *DBA*, 5th edition 2008, Art. 11 para. 49.

¹⁶⁹ TISCHBIREK, in: Vogel/Lehner (fn. 168), Art. 10 para. 210.

ner who is rewarded with a profit share receives dividends under these treaties, whereas one entitled only to a fixed payment obtains interest.¹⁷⁰

Since a typical limited partner and an atypical silent partner are considered to be co-entrepreneurs, their income is treated as business profit under Art. 7.¹⁷¹ Thus, their income is taxable in Germany if it is attributable to a German permanent establishment.

bb) Participating loan

Earnings from participating loans are interest according to the OECD Model Convention. However, most German tax treaties extend the definition of dividends¹⁷², so that Germany is entitled to a limited deduction at source on income from participating loans. Since there is no definition for the term *partiarisches Darlehen* in the particular treaties, the German interpretation of the term is relevant.¹⁷³ Thus, a contract of loan entitling the creditor to a share of the turnover is a participating loan under the treaty.

If there is no such extension, as for example in the treaty with the UK¹⁷⁴, Germany does not have the authority to tax the income, unless the arrangement can be characterised as silent partnership as consequence of the intent of the parties to pursue a common purpose.¹⁷⁵

cc) Jouissance right

Jouissance rights are mentioned in the Model Convention's definition of dividends. However, due to the limiting term "not being debt claims" and the last relative clause referring to the source coun-

¹⁷⁰ WASSERMEYER, in: Debatin/Wassermeyer, DBA, 105th sub. 2005, Model Convention, Art. 10 para. 115.

¹⁷¹ BFH, BStBl. II 1999, p. 812 (813).

¹⁷² Cf. the German treaties with Austria (Art. 10 [3]), France (9 [6]), Switzerland (10 [4]), and the US (10 [5]).

¹⁷³ Art. 3 (2) OECD Model Convention.

¹⁷⁴ Cf. Art VI (4).

¹⁷⁵ *Bundesministerium der Finanzen* (Federal Ministry of Finance), 11-16-1987, BStBl. I 1987, 740.

try's tax law, only payments on equity-like *jouissance* rights are dividends according to the Model Convention.¹⁷⁶

There is no German tax treaty expressly extending the definition to debt-like *jouissance* rights. Nevertheless, some German tax treaties include a general clause extending the definition of dividends to all obligations entitling the creditor to participate in the profit.¹⁷⁷ *Jouissance* rights granting a part of the profit are enveloped by such clauses, whereas other debt-like *jouissance* rights, for instance those entitling the bearer to a fixed interest irrespective of the corporation's profit as well as a part of the latent gains, are not.

d) Conclusion

In differentiating between debt and equity under German tax law, the focus is on economic substance and not legal formalism. Therefore, the means by which the financier is compensated for his capital investment is decisive.

In domestic cases, the question is how to distribute the tax burden between two potential taxpayers – the capital-raising entity and the investor. In principle, an investment is treated as equity if the investor participates in profits and latent gains and thus bears commercial risk. However if the investment is regarded as a partnership because of a common purpose shared by the parties, a participation in losses is also necessary in addition to the joint purpose in order to treat the investment as equity.

In international cases, the question is how to allocate taxing rights between the country of source and the country of residence. The German international tax law assigns at least a limited taxation power to the source country if earnings of a German business are transferred abroad. This is the case if the investor shares in profits, turnovers or latent gains. Not all German tax treaties have

¹⁷⁶ FG Köln EFG 2004, p. 659 (661); TISCHBIREK in: Vogel/Lehner (fn. 168), Art. 10 para. 194.

¹⁷⁷ Cf. Art. 9 (6) of the French-German treaty.

adopted this guideline completely. In particular, a *jouissance* right granting only a share of the latent gains and no share of the profits is usually not covered by the definition of dividends.

IV. Switzerland

1. Introduction

Switzerland is divided into a French-speaking, an Italian-speaking and a German-speaking part. But throughout the whole country, the same civil code, regulations and case law have to be applied. This must be done regardless of which language is used. But as a matter of fact, because of the language barrier, it happens from time to time, that there is only a limited cross-language exchange of interpretations in specific parts of law. Apparently this is also true in the field of hybrid financial instruments, as it is related to the Swiss Code of Obligations (CO; Obligationenrecht; SR 220).

Art. 58 of the Federal Act on Direct Federal Taxation (DFTA; Bundesgesetz über die direkte Bundessteuer; SR 642.11) states: “The taxable net profit is composed of: a. the balance shown in the profit and loss account, taking account of the profit carried forward from the previous year; [...]”¹⁷⁸ Therefore, the assessment of the taxable profits is closely connected to the financial statements. The relationship between the balance sheet and the taxable net profit is generally known as the “principle of dependence” (Massgeblichkeitsprinzip). This means that a corporation has to prepare the annual financial statements according to corporation and accounting rules (Art. 660 et seq. CO). In the second step, the taxable profits are assessed after making tax adjustments.

2. Corporate and Accounting Law

a) General Aspects of Debt and Equity

aa) Legal qualification vs. substance over form

¹⁷⁸ BAUEN/BERNET, Swiss Company Limited by Shares, N 1060.

There are no explicit legal definitions of the terms asset, debt or liability in the current Swiss Civil Code. However, under the new draft of a Swiss Code of Obligations (D-CO) published in December 2007, such definitions will be introduced.¹⁷⁹ Similar to the framework of the International Accounting Standards Board, equity in Swiss accounting law is the residual interest in the assets of the entity after deducting all its liabilities.¹⁸⁰ An asset is a resource controlled by the entity. It comes from a result of past events from which future cash is expected to flow to the entity. Liabilities are present obligations of the entity arising from past events. The settlement of a liability is expected to result in an outflow from the entity of resources embodying cash.¹⁸¹

The difference between debt and equity in Swiss corporation law is inconsistent. In the French-speaking part of Switzerland, the qualification follows legal criteria only.¹⁸² It is completely irrelevant, whether or not the economic reality is different from the legal form. The legal re-characterisation of debt as equity is possible only if a creditor does not act in good faith or if a manifest abuse of law occurs.¹⁸³ The German-speaking (and more accounting-related) doctrine favours the economic approach known as “substance over form”.¹⁸⁴ This doctrine takes into account that the substance of transactions (or other events) is not always consistent with their legal form. Most events are legally and economically presented in the same manner. BÖCKLI represents an intermediary doctrine. In his opinion, the term “substance over form” is an unjustified simplification. Economic activities must be pursued within the boundaries of the legal forms of law. The result of the business, the assets and the protected legal positions are legally enforceable and protected. According to his doctrine, a contract is an instrument for labelling a concrete situation. But in the case that the beneficial interest and the managerial authority are granted to a third person, the property should be reassigned to the beneficial owner.¹⁸⁵

¹⁷⁹ BBI 2008, 1751 et seq.; MÜLLER, Rahmenkonzept, 400 et seq.

¹⁸⁰ Art. 959 para. 4 D-CO.

¹⁸¹ Art. 959 para 2 and 5 D-CO; MÜLLER, Rahmenkonzept, 400, 401 et seq.

¹⁸² BGE 121 III 319 (323 et seq.); RUEDIN, Droit des sociétés, N 1004 et seq.; TORRIONE, CR CO II, Art. 663a CO N 15.

¹⁸³ Art. 2 Swiss Code Civil (CC; SR 210). See also BGE 121 III 319 (321); BGE 102 III 165 (169); BGE 92 II 164; BGE 81 II 455 (458); MEIER-HAYOZ/FORSTMOSER, Schweizerisches Gesellschaftsrecht, § 1 N 11; FORSTMOSER/MEIER-HAYOZ/NOBEL, Schweizerisches Aktienrecht, § 62 N 47 ff.; RUEDIN, Droit des sociétés, N 744 ff.

¹⁸⁴ BGE 106 Ib 145 (149); BOEMLE/LUTZ, Der Jahresabschluss, 118.

¹⁸⁵ BÖCKLI, Schweizer Aktienrecht, § 8 N 166 et seq.

Hybrid types of debt and equity like equity-substituting loans (kapitalersetzende Darlehen) and shareholder loans (Aktionärsdarlehen), convertible bonds (Wandelanleihen) or participating loans (partiarische Darlehen) are ambiguous. A contract has to be judged under a holistic perspective to determine its legal nature. Ambiguous contracts must be interpreted.¹⁸⁶ Important factors to determine the true purpose and legal nature of a contract are, for instance, the effective intention of parties, the purpose of the contract or the surrounding circumstances during formation and performance of the contract.¹⁸⁷ It is fundamental to analyse the purpose of the agreement. The most important criterion for the distinction refers to whether a debt contract (obligation), or a contract of partnership is given. The parties to an obligation have opposed interests. That is to say the purpose of the obligation is that one party gives money in exchange for services or goods.¹⁸⁸ Contrary to the debt contract, in the contract of partnership all partners have common interests (*affectio societatis*).¹⁸⁹ A partnership is a contractual relationship between two or more persons to attain a joint purpose with joint endeavours or means.¹⁹⁰ Hence, a contract is considered as a debt, if the cause is an obligation, not a contract of partnership.¹⁹¹ Profit (and loss) sharing is an indication for the existence of a contract of partnership. But there are also obligations such as participating loans which require the sharing of risk and profit.¹⁹² Similar to the participating loan is the silent partnership (dormant partnership). The difference between these two contracts is that the silent partnership is a contract of association and not an obligation. Veto rights are non-distinctive because they exist in obligations and partnerships. Co-management is only found in partnerships, not in (participating) loan contracts.¹⁹³ Parties of an obligation might avoid forming a company because of the liability for risks. Therefore an agreement should be stated clearly without ambiguity.¹⁹⁴

bb) Legal consequences

¹⁸⁶ BUCHER, Law of Contracts, 112 et seq.

¹⁸⁷ GAUCH/SCHLUEP/SCHMID, Obligationenrecht, N 1196 et seq.

¹⁸⁸ SCHWENZER, Schweizerisches Obligationenrecht, N 3.21.

¹⁸⁹ MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 1 N 66.

¹⁹⁰ Art. 530 para. 1 CO; MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 1 N 66 et seq.

¹⁹¹ BGE 121 III 319 (320).

¹⁹² BGE 99 II 303 (306 f.) E. 4c); HUGUENIN, Obligationenrecht, N 568 und N 573; HONSELL, Schweizerisches Obligationenrecht, 256.

¹⁹³ BGE 94 II 122 (124 et seq.); MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 15 N 33 et seq.

¹⁹⁴ LENGNAUER ET. AL., Company Law, N 11.

The qualification as debt or equity has legal consequences. If the last annual balance sheet shows that at least half of the capital stock is no longer covered by net assets, the board of directors is obliged to immediately convene a general meeting of stockholders and to inform them of the situation.¹⁹⁵ A declaration of insolvency has to be filed with the competent county court, if the company's assets no longer cover its liabilities.¹⁹⁶ If the company enters the stage of bankruptcy proceedings, the administrators of the bankruptcy court liquidate all assets.¹⁹⁷ Outside creditors are in a better position because they will receive liquidation dividends prior to the rest of the creditors.¹⁹⁸ Another legal consequence is that investors cannot claim restitution of the amount paid-in.¹⁹⁹ Restitution can only be granted, if the company is dissolved or by means of a resolution of the general assembly of shareholders.²⁰⁰ Investors have the right to receive dividends, i.e., to proportionate share of the balance sheet profit to the extent this is provided for by law or in the articles of association for distribution among the shareholders.²⁰¹ In case of a loss, the shareholders cannot receive dividends. By contrast, the creditors have rights to receive principal and interest payment according to their individual agreement.

b) Hybrid Capital

aa) Silent Partnership and Profit Participating Loan

If a (simple) partnership²⁰² has a silent partner who still shares in the profits and losses of the business, but who does not get involved in its management and his association with the partnership is not publicly known, we speak of a silent partnership.²⁰³ The CO lacks regulation of the silent partnership. Its legal nature is thus controversial. The older doctrine was considering the silent partner-

¹⁹⁵ Art. 725 para. 1 CO.

¹⁹⁶ Art. 725 para. 2 CO.

¹⁹⁷ Art. 221 et seq. DCBA (Federal Act of Debt Collection and Bankruptcy; Bundesgesetz über Schuldbetreibung und Konkurs; SR 281.1).

¹⁹⁸ Art. 219 DCBA; LORANDI, AJP 11 (2006), 1263 ff.

¹⁹⁹ Art. 680 para. 2 CO.

²⁰⁰ Art. 732 CO; Art. 736 et seq. CO; BÖCKLI, Schweizer Aktienrecht, § 8 N 262.

²⁰¹ Art. 660 para. 1 CO.

²⁰² Art. 530 et seq. CO.

²⁰³ MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 15 N 5 et seq.

ship as a special type of loan²⁰⁴ or as a limited liability partnership (Kommanditgesellschaft)^{205, 206}. Under existing law, the latest doctrine is appraising the silent partnership as a unique type of simple partnership with modifications. If the involvement of the silent partner is publicly unknown and if he must not co-manage the business, the legal form of this contract may be doubted. In such a case, it could be rather a participating loan instead of a dormant partnership.

The profit participating loan is an agreement between the lender and the borrower.²⁰⁷ The lender conveys money to the borrower, and the borrower is obligated to repay the same amount of money. Opposite to the situation for normal loans, the interest rate in a profit participating loan depends on the profit and loss of the borrower.²⁰⁸

bb) Equity-Substituting Loan and Shareholder Loan

Under Swiss Law, the legal concept of equity-substituting or shareholder loans was first mentioned by VON GREYERZ. In his opinion, debt or hybrid capital has to be re-characterised as equity, if an independent and unrelated party would not issue debt-capital in the same situation and if only the loan can help to restructure the business.²⁰⁹ If a loan fulfils these two qualifications, a loan should be judged as equity. In doing this, one should follow the legislation concerning restitution²¹⁰, provisions about the mandatory accumulation of capital surplus (gesetzliche Reservenbildung)²¹¹, the mandatory notification of loss of capital or insolvency²¹² and the prohibition of interest payment.²¹³ Despite the fact that the majority of the doctrine is treating an equity-substituting loan as equity, the Federal Supreme Court rejects this opinion. Instead, the Supreme Court treats an equity-substituting

²⁰⁴ Art. 312 et seq. CO.

²⁰⁵ Art. 594 et seq. CO.

²⁰⁶ MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 15 N 8 et seq.

²⁰⁷ Art. 312 et seq. CO.

²⁰⁸ HONSELL, Obligationenrecht, 256; HUGUENIN, Obligationenrecht, N 568 and N 573.

²⁰⁹ VON GREYERZ, in: FS Vischer (1983), 547 (552).

²¹⁰ Art. 680 para. 2 CO.

²¹¹ Art. 670 et seq. CO.

²¹² Art. 725 CO.

²¹³ BGer-decision 5C.226/2005 E. 4, 5th of March 2006; BÖCKLI, Schweizer Aktienrecht, § 13 N 779; GLANZMANN, Der Darlehensvertrag mit einer Aktiengesellschaft aus gesellschaftsrechtlicher Sicht, 144 and 158; HOLD, Das kapitaleretzende Darlehen im schweizerischen Aktien- und Konkursrecht, 194 et seq. and 206 et seq; STÖCKLI, Das Kapitaleretzende Darlehen im Konkurs der Aktiengesellschaft, ST 81 (2007) 662 (665 et seq.).

loan as a subordinated claim (Art. 725 para. 1 CO). Economically, it is the same as equity, because in the bankruptcy liquidation, the subordinated claims are the least to get liquidation dividends. But from a legal perspective, subordinated claims are still debt.

cc) Subordinated Claim

The creditor, who has a subordinated claim against the company, declares subordination according to Art. 725 para. 1 CO. That is an instrument to avert the threat of bankruptcy during the over-indebtedness.²¹⁴ Over-indebtedness is given if the assets no longer cover equity and liabilities.²¹⁵ If a sufficient amount of declarations of subordination has been made and if the auditor confirms that compliance with law is given, the judge may postpone the commencement of the bankruptcy proceedings.²¹⁶ In order to declare a legally binding subordination of a claim, the following requirements have to be met:

- The declaration has to be made in writing. Otherwise the auditor will not confirm its validity.²¹⁷
- The period of the subordination has to be at least as long as the over-indebtedness lasts.
- An extending term of payment must be granted or else the creditor can demand payment when due.²¹⁸
- The execution of the declaration of subordination should be economically feasible for the person who subordinates his claim. Otherwise, if he has been declared bankruptcy, the bankruptcy administrator can legally challenge the declaration of subordination with a action of fraudulent conveyances or transfers.²¹⁹

In economic terms, subordinated debt is similar to equity because the creditor cannot reclaim his money, but from a legal point of view, it is still a liability.

dd) Bonds, Convertible Bonds and Option Bonds

²¹⁴ MEIER-HAYOZ/FORSTMOSER, Gesellschaftsrecht, § 16 N 86.

²¹⁵ BAUEN/BERNET, Swiss Company Limited by Shares, N 172.

²¹⁶ Art. 725a CO.

²¹⁷ PS 290 N DD.

²¹⁸ FORSTMOSER/MEIER-HAYOZ/NOBEL, Schweizerisches Aktienrecht, § 50 N 219.

²¹⁹ Art. 288 DCBA; VON GREYERZ, SAG 55 (2007) 28 (29).

Larger companies are often issuing bonds.²²⁰ Bonds are a type of security with interest coupons and a maturity date on which the issuer has to repay the nominal amount. There are various types of bonds. They can be combined with a separate option rights to subscribe or acquire shares.²²¹ This type of security is called option bond. Convertible bonds give the bondholder the right to trade the bond for several shares within or at a given time.²²² As soon as the bond is being converted into shares, the bondholder is no longer a debtor. He turns into an investor. His position is assessed only from a legal perspective.

If the trading conditions were fixed in advance and the bondholder must trade his security for shares, it is referred to as a mandatory convertible bond.²²³ In economic terms, a mandatory convertible bond is considered equity, not debt.²²⁴ From a legal perspective, a mandatory convertible bond is a bond-issue mixed with an equity-issue depending on the redemption of the debt.²²⁵ The possibility to convert debt into equity enhances the value of the convertible bond.

Convertible bonds are an indirect way for corporations to issue shares. The capital increase is being carried out with a simplified procedure, the conditional increase in capital.²²⁶ Instead of payback, the bondholder receives shares as redemption for the bond. In favour of the conversion and option rights, Art. 653d para. 3 CO provides protection against dilution of votes and the right to participate in dividends.

The bondholder has normal creditor rights until he executes his conversion right. After the exchange into equity, he is treated like any other stockholder.

ee) Preference Shares, Certificates of Participation and Profit Sharing Certificates

²²⁰ Art. 1156 CO et seq.

²²¹ Art. 653 CO et seq.

²²² BERNET/BAUEN, Swiss Company Limited by Shares, N 200.

²²³ ISLER/ZINDEL, BSK-OR II, Art. 653 N 10a.

²²⁴ KOLB/VOLKART, ST 77 (2003) 513 (516).

²²⁵ KÖNDGEN/DAENIKER, ZGR Sonderheft 16 (2000) 265 (266).

²²⁶ Art. 653 et seq. CO.

Preference shares are not much different from normal shares. The only difference is that preference shares provide additional financial entitlements such as a higher dividend payment, a cumulation distribution preference (i.e. preferred shareholders will accrue an entitlement to distributions for each year – if the dividends are not paid during a year, they accumulate in the amount until the general assembly meeting declares distribution of dividends) or preference when the company is dissolved.²²⁷ Certificates of participation are a kind of non-voting share. They have the same characteristics as common shares except for the non-voting nature.

Preference shares and certificates of participation, both are uncontestedly categorised as equity.

Profit sharing certificates can be granted to former shareholders, creditors or employees.²²⁸ These securities must not have a face value. Issue again cannot be performed against an exchange value. Profit sharing certificates represent compensation for a previous debt relief.²²⁹ All these securities undisputedly represent equity rights.

c) Conclusion

This country report comes to the conclusion that a lot of research needs to be done in the field of debt and equity in order to eliminate the contradictory differences in doctrines. The French-speaking doctrine strictly favours a qualification by its legal form.²³⁰ The major part of the German-speaking doctrine in Switzerland favours the “substance over form” qualification method.²³¹

The distinction between debt and equity has to be made in the context of the qualification of the contract. If a partnership is given, it is an equity type while a debt contract (obligation) is characterised by the opposing interests of the contract parties. Partners share a common purpose. An apparent type of hybrid capital, where the distinction of debt and equity is rather difficult, is the convertible bond. The change from debt to equity occurs when the bond is converted into equity.

²²⁷ Art. 654-656 CO.

²²⁸ Art. 657 CO.

²²⁹ FORSTMOSER/MEIER-HAYOZ/NOBEL, *Schweizerisches Aktienrecht*, § 47 N 3 et seq.

²³⁰ BGE 121 III 319 (323 et seq.).

3. Tax Law

In the following chapter an overview of the basic framework in respect of mezzanine capital in the Swiss tax law is given. Secondly, the question is pursued, whether or not there are criteria of distinction for the differentiation²³² between equity and debt capital in the Swiss tax law.

a) Mezzanine capital in the Swiss tax law

In the following it is distinguished between the domestic tax law of Switzerland on the one hand and the Swiss international tax law on the other hand. Finally, possible diverging classifications are described.

aa) Domestic tax law of Switzerland

Basically, the notion of debt and equity under civil law is decisive for the classification under tax law as well. In this context one must consider that, according to a position taken in academic literature, the types of legally enforceable ownership rights²³³ are subject to a *numerus clausus*²³⁴; the decisive provisions for these ownership rights can be found within the Code of Obligations²³⁵. Nevertheless, there are some forms of mezzanine capital under Swiss law which are not based on corporate or *in rem* property rights, but on a contractual basis. On the other hand, the view has been taken by some writers that certain forms of mezzanine capital (subordinated loans, subordinated convertible bonds, and profit participating loans²³⁶) must always be regarded as so-called constructive equity capital²³⁷ in the sense of Art. 65 DBG²³⁸; however, this view is not persuasive. Currently, the main distinctions are as follows:

Silent partnerships are neither provided for under the framework of the Code of Obligations nor mentioned within the tax law. They are characterised as so-called simple partnerships²³⁹ according to a strong opinion

²³¹ BGE 106 Ib 145 (149 et seq.).

²³² *Unterscheidungskriterien zur Abgrenzung.*

²³³ *Art der zulässigen Beteiligungsrechte.*

²³⁴ *Meister*, ASA 70 (2001/02), p. 97 (99).

²³⁵ *Obligationenrecht.*

²³⁶ *Nachrangige Darlehen, nachrangige Wandelobligationen und partiarische Darlehen.*

²³⁷ *Verdecktes Eigenkapital.*

²³⁸ Bundesgesetz über die direkte Bundessteuer.

²³⁹ *Einfache Gesellschaft.*

under company law. However, they are not mentioned in the Swiss tax law at all, neither in the academic literature nor in the jurisprudence²⁴⁰.

Earnings from profit participating loans²⁴¹ are regarded as income from debt capital despite their dependence of profit²⁴². Earnings from subordinated loans²⁴³ are also treated as income from debt capital.

There is a very sophisticated taxation regime regarding option bonds and convertible bonds²⁴⁴ within which one must differentiate between the so-called classic and non-classic bonds²⁴⁵ in the first place. As a second step, if necessary, one must distinguish between the so-called transparent and non-transparent products²⁴⁶ within the range of non-classic bonds. Mandatory convertible bonds²⁴⁷ must be regarded as so-called reverse convertibles which are transparent products as a rule. If parts of all mentioned bonds are subject to tax (at all), the earnings will result from debt capital.

Participation certificates²⁴⁸, a Swiss particularity, constitute corporate ownership rights²⁴⁹ like shares and must therefore be allocated to the equity capital. They raise no further problem. Preferred stock²⁵⁰ is equity capital, too.

The classification of profit-sharing certificates²⁵¹ (a specific type of *jouissance* rights) is not uncontroversial. However, the better arguments can be made in favour of a classification as ownership rights – thus, profit-participating certificates constitute equity capital.

Within the framework of the Profit Tax²⁵² the so-called participation deduction²⁵³ according to Art. 69 et seq. DBG, which leads to an indirect exemption of the net earnings from participations in other corporations that are resident as well as subject to taxation within Switzerland, only applies to a (corporate) ownership rights. The classification of the different forms of mezzanine capital is not always uncontroversial (profit-sharing certificates).

²⁴⁰ They just seem to have no practical relevance.

²⁴¹ *Partiarische Darlehen*.

²⁴² *Gewinnabhängigkeit*.

²⁴³ *Nachrangige Darlehen*.

²⁴⁴ *Options- und Wandelanleihen*.

²⁴⁵ *Klassische und nicht klassische Anleihen*.

²⁴⁶ *Transparente und nicht transparente Produkte*.

²⁴⁷ *Pflichtwandelanleihen*.

²⁴⁸ *Partizipationsscheine*.

²⁴⁹ *Beteiligungsrechte*.

²⁵⁰ *Vorzugsaktien*.

²⁵¹ *Genussscheine*.

bb) Swiss international tax law

Within the framework of Swiss international tax law one must distinguish between the unilateral international tax law of Switzerland and the additional impact of bilateral double taxation conventions of Switzerland.

(1) Unilateral international tax law of Switzerland

Regarding mezzanine capital the Withholding Tax²⁵⁴, being the final burden for the non-resident tax payer within an inbound situation, plays the decisive role. In this context, Swiss law distinguishes as follows:

Particular items of the (current) earnings from option and convertible bonds, and also mandatory convertible bonds are subject to the Withholding Tax according to Art. 4 I lit. a VStG²⁵⁵. Thus, these forms of mezzanine capital are allocated to the qualified debt capital²⁵⁶, namely to the bonds²⁵⁷, for the purpose of the Withholding Tax in this respect.

Current earnings from participation certificates, profit-sharing certificates, and preferred stock are subject to the Withholding Tax according to Art. 4 I lit. b VStG. Hence, these forms of mezzanine capital are allocated to the equity capital for the purpose of the Withholding Tax.

Current earnings from profit participating loans and subordinated loans are not subject to the Withholding Tax since both forms of financing are neither bonds nor ownership rights..

(2) Bilateral Double Taxation Treaty Law of Switzerland

²⁵² *Gewinnsteuer.*

²⁵³ *Beteiligungsabzug.*

²⁵⁴ *Verrechnungssteuer.*

²⁵⁵ *Bundesgesetz über die Verrechnungssteuer.*

²⁵⁶ *Qualifiziertes Fremdkapital.*

²⁵⁷ *Obligationen.*

With regard to Swiss double taxation conventions, the first question in respect of mezzanine capital refers to, whether income from it is characterised as dividend or interest – in other words, whether it is allocated to the equity capital or to the debt capital.

Generally, with regard to dividends, all examined DTC like the OECD model convention provide a right of taxation of the state of residence²⁵⁸ of the recipient as well as a regularly limited right of taxation of the state of source²⁵⁹. With regard to interest, the OECD model convention contains both a right of taxation of the state of residence of the recipient and a limited right of taxation of the state of source, whereas the examined DTC only lay down a right of taxation of the state of residence.

In the context of dividends, only the DTC Switzerland-Germany contains a special provision for participations in a business as a silent partner in the sense of the German law²⁶⁰, which beyond that applies to income bonds²⁶¹ and profit participating loans; apart from that, there are hardly any particularities in respect of the right of taxation with regard to mezzanine capital. Moreover, only the DTC-Switzerland-Germany contains a special provision for the sale of controlling participations²⁶².

Participation certificates, profit-sharing certificates, and preferred stock are equity capital according to the OECD model convention and all examined DTC.

In the context of taxation of interest, profit participating loans must be regarded as debt capital according to the OECD model convention, the DTC²⁶³ Switzerland-France, the DTC Switzerland-UK, the DTC Switzerland-USA, and the DTC Switzerland-Austria, whereas they must be regarded as equity capital according to the DTC Switzerland-Germany. Furthermore, subordinated loans, option and convertible bonds, and also mandatory convertible bonds must be regarded as debt capital according to the OECD model convention and all examined DTC.

cc) Possible diverging classifications

²⁵⁸ *Ansässigkeitsstaat.*

²⁵⁹ *Quellenstaat.*

²⁶⁰ *Beteiligungen an einem Handelsgewerbe als stiller Gesellschafter im Sinne des deutschen Rechts.*

²⁶¹ *Gewinnobligationen.*

²⁶² *Veräußerung von wesentlichen Beteiligungsrechten.*

²⁶³ *Double taxation agreement(s).*

Against this background, it can be said that solely with regard to the domestic and international classification of profit participating loans, there is a divergence in the allocation to the equity capital and the debt capital, respectively. Whilst they are regarded as debt capital under the domestic tax law of Switzerland the DTC Switzerland-Germany qualifies them as equity capital, whereas the OECD model convention as well as all other examined DTC regard them as debt capital in turn.

b) Criteria for the differentiation between equity and debt capital in the Swiss tax law?

While the preceding analysis has focused on the current treatment of different financial instruments, the following remarks examine, whether and, if applicable, to what extent there are general criteria for the differentiation between equity and debt capital under Swiss tax law. In doing so, one has to distinguish between the domestic tax law of Switzerland and the Swiss international tax law.

Theoretically, the following “material”²⁶⁴ criteria for the differentiation between equity and debt capital come into question: type of participation²⁶⁵, common purpose²⁶⁶, control rights²⁶⁷, and also participation in profits/losses as well as in liquidation proceeds²⁶⁸.

aa) Domestic tax law of Switzerland

(1) General

It is remarkable that extensive conflicts of qualification regarding the question, whether a form of mezzanine capital must (rather) be allocated to the equity capital or (rather) to the debt capital, are basically unknown under domestic tax law of Switzerland. According to the only author in academic literature, who deals

²⁶⁴ *Materiell.*

²⁶⁵ *Art der Mitinhaberschaft.*

²⁶⁶ *Gemeinsamer Zweck.*

²⁶⁷ *Mitwirkungs- und Verwaltungsrechte.*

²⁶⁸ *Gewinn-/Verlustbeteiligung und Beteiligung am Liquidationserlös.*

slightly more comprehensive with the taxation of mezzanine capital in Switzerland²⁶⁹, the question regarding the differentiation between equity and debt capital on the basis of different material criteria is not raised at all under tax law. Relevant jurisprudence could not be found either.

The allocation of each of the aforementioned types of mezzanine capital to the relevant tax provisions for current income from so-called ownership rights in the broader sense²⁷⁰ (Artt. 20 I lit. c s. 1 and 20 I^{bis} DBG, Art. 4 I lit. b VStG), and also to the respective tax provisions for current income (and, if applicable, also capital gains) from so-called debt claims in the broader sense²⁷¹ (Art. 20 I lit. a s. 1 DBG, as well as – only for bonds – Art. 4 I lit. a VStG, and, if applicable, also Art. 20 I lit. b DBG) does not involve any in-depth substantive analysis. The concepts of ownership rights in the broader sense and debt claims in the broader sense were chosen since the earnings from the respective ideal types – formal equity capital and formal debt capital – are subject to tax according to the relevant provisions in each case.

(2) Ownership rights in the broader sense

Art. 4 I lit. b VStG enumeratively mentions the earnings from stock (whereby preferred stock is also meant), participation certificates, and profit-sharing certificates for the purpose of the Withholding Tax – all of these forms of mezzanine capital are indisputably ownership rights in the broader sense to this extent. The allocation of preferred stock to the ownership rights in the broader sense is also not problematic for the purpose of the Income Tax²⁷² since earnings from them are dividends in the sense of Art. 20 I lit. c sent. 1 DBG. The same applies with respect to earnings from participation certificates which are even explicitly mentioned by the provision regarding the so-called partial taxation of ownership rights in the broader sense, Art. 20 I^{bis} DBG. – Concerning all of the just mentioned cases there is therefore de facto no need at all to search for additional or underlying “material” criteria for the differentiation between equity and debt capital. It is remarkable that all of the just mentioned forms of mezzanine capital are dealt with under company law in the framework of the Code of Obligations²⁷³ under the third division („Die Handelsgesellschaften und die Genossenschaft”) within the 26th title („Die Aktiengesellschaft”) and its first paragraph („Allgemeine Bestimmungen”). From this it can be concluded that the Swiss tax legislator has relied on the classification

²⁶⁹ Namely *Meister*, ASA 70 (2001/02), p. 97-133.

²⁷⁰ *Beteiligungsrechte im weiteren Sinne*.

²⁷¹ *Forderungsrechte im weiteren Sinne*.

²⁷² *Einkommenssteuer*.

²⁷³ *Obligationenrecht*.

within the Code of Obligations as far as all forms of mezzanine capital, which are mentioned within the stock corporation law, are regarded as ownership rights in the broader sense (also) for tax purposes.

Solely with regard to the earnings from profit-sharing certificates, it is necessary to discuss for the purpose of the Income Tax, whether or not they qualify as ownership rights in the broader sense according to Art. 20 I lit. c s. 1 DBG. However, even this question is not approached by any “material” criteria of distinction, but with regard to the essence²⁷⁴ of profit-sharing certificates by regarding them (without any further explanation) as ownership securities of a particular kind²⁷⁵ and qualitatively as ownership rights, respectively. A further argument is the necessity to secure parallel treatment under domestic tax law²⁷⁶ and the treatment under the Withholding Tax rules – it does not make sense why profit-sharing certificates should be classified differently for the purpose of the Withholding tax and the (Direct Federal) Income Tax. Ultimately, this point of view is underpinned by the already mentioned linkage of tax characterisation to the types mentioned in the Code of Obligations²⁷⁷. Therefore, profit-sharing certificates are characterised as ownership rights in the broader sense with regard to the Direct Federal Tax as well.

(3) Debt Claims in the broader sense

For the purpose of the Income Tax it is indisputable that earnings from subordinated loans and particular items of the (current) income from option and convertible bonds, and also mandatory convertible bonds are characterised as “interest” and therefore earnings from debt claims in the broader sense. Moreover, for the purpose of the Withholding Tax it is well-defined what constitutes a bond in the sense of Art. 4 I lit. a VStG; a mere debt claim is not enough. Moreover, particular items of the (current) earnings from option and convertible bonds, and also mandatory convertible bonds are subject to the Withholding Tax. Again, with respect to these cases there is de facto no need to search for any additional or underlying “material” criteria for the differentiation between equity and debt capital.

Furthermore, subordinated loans are not mentioned within the title of the Code of Obligations which deals with corporate law. Indeed, loan bonds²⁷⁸ and similar bonds are referred to in this act when the code explic-

²⁷⁴ *Wesen.*

²⁷⁵ *Beteiligungspapiere besonderer Art.*

²⁷⁶ *Steuerrechtlicher Gleichlauf.*

²⁷⁷ *Obligationenrechtliche Orientierung des Steuergesetzgebers.*

²⁷⁸ *Anleiheobligationen.*

itly mentions the “*creditors* of new loan bonds or similar bonds”²⁷⁹ within the title concerning the corporation; but there is no specific statutory law as to the substance of these bonds. Thus, the mere reference of these bonds within this act does not militate against the above established assumption of the linkage of tax characterisation to the types mentioned in the Code of Obligations.

It is accepted that earnings from profit participating loans are taxed as interest according to Art. 20 I lit. a DBG – therefore, profit participating loans are debt claims in the broader sense despite their dependence of profit and not ownership rights in the broader sense. Thus, even here any “material” criterion, e.g. the dependence on the profit of the corporation, is not crucial. Again, it is de facto not necessary to have any recourse to any of the afore-mentioned “material” criteria of differentiation. The already exemplified linkage of tax characterisation to the types mentioned in the Code of Obligations reveals this, too – the profit participating loan is not mentioned within the title concerning the corporation either.

(4) Conclusion

All forms of mezzanine capital known in Switzerland, which were examined here without exception, can clearly be regarded as either ownership rights in the broader sense or debt claims in the broader sense for the purpose of the domestic tax law of Switzerland as a rule without any in-depth analysis. Therefore, there is de facto no need at all to go back to conceivable “material” criteria of distinction for the differentiation between equity and debt capital – type of participation, common purpose, control rights, and also participation in profits/losses as well as in liquidation proceeds. Thus, it can be stated that a very formal approach prevails.

Obviously there is not the perception of an incentive under domestic tax law of Switzerland to pursue these questions of differentiation which are possibly substantial within other legal systems. This might be connected with the fact that mezzanine capital – all in all – plays only a marginal role within Switzerland²⁸⁰. Moreover, there is only a limited number of types available for mezzanine capital. For example, the Swiss tax law practically knows no silent partnerships; therefore, questions of differentiation between silent partnerships and profit participating loans or profit-sharing certificates which are widely discussed in Germany do not come up in the first place. The already mentioned *numerus clausus* of enforceable ownership rights

²⁷⁹ Highlighting by author.

might be a further reason for this lack of material analyses. But also with respect to debt claims in the broader sense which are not mentioned in the Code of Obligations only the respective standard types of mezzanine capital are employed²⁸¹.

bb) Swiss international tax law

Again, also under international tax law, one must distinguish between the unilateral international tax law of Switzerland and the bilateral double taxation convention law of Switzerland.

(1) Unilateral international tax law of Switzerland

The enumerative nomination of several types of mezzanine capital within the Withholding Tax law and the resulting very formal approach has already be mentioned. For the purpose of the Withholding Tax one can distinguish between ownership rights in the broader sense and qualified debt claims in the broader sense²⁸², namely the bonds, too. Thus, there is de facto no need to base on “material” criteria for the differentiation between equity and debt capital within the unilateral international tax rules of Switzerland either. So a very formal approach prevails here as well.

(2) Swiss Double Taxation Conventions

²⁸⁰ Cf. *Credit Suisse Economic Research*, Economic Briefing Nr. 42, p. 14: „In der Schweiz sind Mezzanine-Instrumente eine noch kaum bekannte Finanzierungsform und kommen deshalb noch wenig zur Anwendung.“

²⁸¹ For example, the mezzanine products issued by the *Credit Suisse Anlagestiftung*, *CSA Mezzanine* and *Preferred Pooled Shares – PREPS™*, are exclusively granted as *subordinated loans*, cf. *Credit Suisse Group*, Pressemitteilung vom 28.09.2005, p. 1 et seqq.

²⁸² *Qualifizierte Forderungsrechte im weiteren Sinne*.

One wonders, whether any “material” criteria of distinction for the differentiation between equity and debt capital must be applied at least within the bilateral double taxation convention law of Switzerland, or whether one can only realise a very formal approach here, too.

Following common practice around the world, the double taxation conventions of Switzerland distinguish between the notion of a “dividend” and the notion of “interest”.

The first part of the provision on dividends under the OECD model convention and also under the DTC²⁸³ which Switzerland negotiated with Germany, France, the UK, and Austria includes an enumeration of particular types of financial instruments. This first part of the provision on dividends includes income from profit-sharing certificates^{284, 285} and preferred stock²⁸⁶.

In addition, the second part of the provision on dividends under the OECD model convention as well as the corresponding provision under all of the examined Swiss DTC includes income from “other rights” “participating in profits”. Thus, the “material” element of a participation in profits seems to play prima facie a substantive role for the characterisation. However, “other rights” are per definitionem only such ones which convey a corporate share^{287, 288} and which are securitised²⁸⁹. Ultimately, it is therefore also necessary under the DTC law that ownership rights in the broader sense are involved. That is why a very formal approach prevails here, too. By contrast, the participation in profits as such plays at best a role in a second step²⁹⁰. This second part of the term of dividends includes income from participation certificates.

Income from profit participating loans does not fall under the concept of dividends under the OECD model convention and also the DTC which Switzerland negotiated with France, the UK, the USA, and Austria. – However, income from profit participating loans is enumeratively mentioned within the supplement to the

²⁸³ However, within the DTC Switzerland-USA *profit-sharing certificates* come under the second (as well as the third) part of the term of dividends.

²⁸⁴ Nota bene: the OECD model convention itself talks about “*jouissance*’ shares” instead of “*profit-sharing certificates*”.

²⁸⁵ Though parts of the literature make higher demands on this.

²⁸⁶ Via the term of *shares*.

²⁸⁷ *Gesellschaftsanteile*.

²⁸⁸ Solely within the DTC Switzerland-France this is not obviously anyway.

²⁸⁹ *In Wertpapierform verbrieft*.

²⁹⁰ This is also demonstrated by paragraph 4 of the protocol to the DTC Switzerland-USA: „[Lediglich] ein Kriterium [...]“ [addition and omission by author].

third part of the term of dividends within the DTC Switzerland-Germany²⁹¹. Thanks to this explicit reference there is no need of further “material” criteria of distinction here either.

The article on interest of the OECD model convention has recourse to income from debt-claims of every kind – and therewith to debt claims in the broader sense; that is why it is also rather formally coined. The notion of interest under the examined DTC include without exception income from debt-claims of every kind, too, so that the same rule applies. Even the commonly used language “whether or not carrying a right to participate in the debtor’s profits” does not change this approach since this caveat does not limit the term of interest; moreover, a participation in profits is neither characteristic for a debt claim, nor does change its qualification as a debt claim, that is why it cannot be a decisive criterion of differentiation of the first rank here either. This first part of the term of interest includes income from profit participating loans²⁹² and subordinated loans.

Furthermore, the article on interest of the OECD model convention explicitly mentions income from bonds²⁹³, and again includes therefore an exemplary enumeration. The same applies to all examined DTC except for the DTC Switzerland-Germany which indeed only uses the coextensive term debentures²⁹⁴. Insofar, particular items of the (current) income from option and convertible bonds, and also from mandatory convertible bonds are interest in the sense of the respective article on interest according to all examined DTC.

Thus, in the context of Swiss DTC law there is de facto no need concerning mezzanine capital to have recourse to any “material” criteria for the differentiation between equity and debt capital – type of participation, common purpose, control rights, and also any participation in profits/losses as well as in liquidation proceeds. The qualification of the different types of mezzanine capital as ownership rights in the broader sense or debt claims in the broader sense is decisive; therefore, eventually, a very formal approach prevails.

Concerning the treatment of income from profit participating loans there is a different classification under the regime of the DTC Switzerland-Germany for two reasons: On the one hand its article on dividends explicitly mentions income from profit participating loans, on the other hand its article on interest contains a

²⁹¹ According to the wording of Art. 10 IV DTC Switzerland-Germany this also applies to profit participating loans in the sense of the Swiss law since the constraint „im Sinne des deutschen Rechts“ solely refers to „Beteiligungen an einem Handelsgewerbe als stiller Gesellschafter“.

²⁹² However, thanks to a so-called *dividend caveat* (*Dividendenvorbehalt*) this does not apply to the *DTC Switzerland-Germany*, that is why income from profit participating loans qualify as *dividends* hereafter.

²⁹³ The English version of the OECD model convention *also* includes the term *debentures* (*Schuldverschreibungen*) whilst the German version has *only* recourse to *debentures*.

²⁹⁴ *Schuldverschreibungen*.

dividend caveat²⁹⁵. This demonstrates that the participation in profits does not matter as a criterion of differentiation in this respect, but the enumerative nomination within the prior article on dividends does.

V. United Kingdom

1. Introduction: The Role of Hybrid Capital in the United Kingdom

Driven by the needs of railroad funding, hybrid capital appeared on the financial landscape of the United Kingdom (UK) in the middle of the 19th century.²⁹⁶ Originally evolving from the desire of company founders to receive a preferential benefit for their commitment, companies soon found out about the blessing effects of profit dependency of interests payments in order to avoid bankruptcy risks. Today, the primary motive of issuing hybrid capital is its qualification under capital adequacy requirements for banks, achieving higher equity ratios and tax deductibility of equity-like instruments.²⁹⁷

2. Hybrid Capital in UK Company and Financial Accounting Law

a) Sources of Law and Status of Reform Legislation

The 2006 reform of the central source of statutory company law, the Companies Act, left the basic regulatory concepts of British corporate law widely untouched.²⁹⁸ A slight tendency towards a further codification of common law can be perceived, most prominently in the field of directors' duties²⁹⁹, but without material effects on the *lex lata* of corporate finance. Another area of reform was

²⁹⁵ *Dividendenvorbehalt*.

²⁹⁶ RIPLEY, *Railroads: Finance and Organization*, 95; BASKIN/MIRANTI, *A history of corporate finance*, 151.

²⁹⁷ See BURGESS, *Corporate Finance Law*, 313; MURPHY, *Understanding Risk*, 171; HANNAM, *The Tax Journal* 2008, 11 August 2008, 9 (9).

²⁹⁸ DAVIES/RICKFORD, *ECFR* 1/2008, 48 et seq.; changes to corporate finance law were restricted to facilitating financial assistance and capital reductions, DAVIES/RICKFORD, *ECFR* 3/2008, 239 (266).

²⁹⁹ Explanatory Notes on the Companies Act 2006, 45.

accounting regulations, with meaningful implications for hybrid instruments: The rather formal approach³⁰⁰ of the Financial Reporting Standard (FRS) 4 was replaced by the substance over form concept of FRS 25, underlining the overall tendency of international convergence in the realm of financial accounting.

b) Fundamentals of Hybrid Instruments in British Corporate Law

aa) Formal Differentiation between Debt and Equity

Like other corporate legal regimes the Companies Act 2006 (CA) adopts a strictly formal approach in order to distinguish between share and debt capital. Share capital is restricted to funds stated in the statement of capital³⁰¹, duly registered with the Companies House³⁰² and subscribed to by the members of the company who are themselves formally registered in the members register.³⁰³ Capital that is not registered in the described way but created by purely contractual agreements qualifies as debt and does not convey statutory shareholder rights if not expressly mentioned.

A further differentiation within the share capital of a company separates between equity share capital and „ordinary“ share capital, primarily³⁰⁴ for the purpose of granting the holders of equity share capital pre-emption rights on new issues.³⁰⁵

bb) Contractual Freedom

The formal distinction between debt and equity does not hinder the British legislator to leave issuers a great extent of freedom to create substantially atypical instruments, thus blurring the formal dichotomy of debt and equity. The fact that party autonomy and flexibility are one of the core policies

³⁰⁰ CHOPPING, Applying GAAP, 428.

³⁰¹ Sec. 10(2) CA. Insofar the statement of capital adopted the function of the memorandum of association, MORSE, Palmer's Company Law annotated Guide to the Companies Act 2006, 64, sec. 10, General Note.

³⁰² Sec. 9(4) CA.

³⁰³ Sec. 112(2) CA; at the stage of foundation, subscription to the memorandum of association is sufficient to achieve membership, sec. 112(1), 16(5) CA.

³⁰⁴ Further purposes are the calculation of merger relief for premium share account, (sec. 612 CA) and the qualification of connected and controlling directors (sec. 254(2)(a), 255 CA).

³⁰⁵ Sec. 548, 560, 561 CA.

of British company governance³⁰⁶ leads to a fundamentally different understanding of hybrid capital compared to the continent: From the perspective of UK corporate law there is often little need to locate hybrid securities on the debt side of the balance sheet, as a wide range of hybrid instruments can be displayed within the share capital of a company. Not surprisingly, preference shares assume a far larger role in the United Kingdom than in Continental Europe. On the other hand, participating debt instruments and silent partnerships are hard to find in Britain.³⁰⁷

cc) Hybrid Securities

(1) Hybrid Equity Securities

The predominant form of hybrid equity securities is the preference share. Its terminology derives from common law and, in order to allow the courts for a broader discretion on their treatment, until today has not been introduced into the Companies Act. Since the famous case of *Birch v Cropper* it has been widely acknowledged that these are shares which entitle their holders to a preference on dividends or capital.³⁰⁸ The rights of the preference shares can be expressly defined, but where there are no explicit provisions, the rights are established through a general presumption of equality³⁰⁹ and a complex canon of assumptions.³¹⁰ Thus, for example, if a share entitles its holder to a fixed preference, common law has established the presumption that he has no right to participate in any further dividends above his preference.³¹¹ In return it is presumed that the preferential dividend is cumulative and arrears of unpaid dividends will be paid in consecutive years.³¹² As the compilation of presumptions shows, the common law model of the preference share tends to carry the characteristics and features of debt capital rather than equity – a result of early British corporate law judica-

³⁰⁶ DAVIES/RICKFORD, 1/ECFR 2008, 48 (51 f.).

³⁰⁷ The British discussion of *silent* or *dormant partnership* rather refers to the question, whether a lender who is entitled to a share in the profits of a partnership qualifies as a partner and is therefore liable, MORSE, Partnership Law, 63.

³⁰⁸ *Birch v Cropper* [1889] 14 App Cas 525, HL; *Re Bridgewater Navigation Co Ltd* [1889] App Cas 525 543, HL; DAVIES, Gower and Davies' Principles of Modern Company Law, 821 FERRAN, Principles of Corporate Finance Law, 151.

³⁰⁹ *Birch v Cropper* [1889] 14 App Cas 525, HL.

³¹⁰ DAVIES, Gower and Davies' Principles of Modern Company Law, 823.³¹¹ *Will v United Lankat Plantations Co* [1914] AC 11, HL; MORSE, Palmer's Company Law, 6.20.

³¹² *Henry v Great Northern Rly* [1857] 1 De G&J 606, 44 ER 858; *Webb v Earle* [1875] LR 20 Eq 556; HANNIGAN, Company Law, 395; MCCORMICK/CREAMER, Hybrid corporate securities: international legal aspects, 13.

ture which led *Lord Evershed*³¹³ to the conclusion that „*the view of the courts may have undergone some change [...] to the disadvantage of the preference shareholders whose position has [...] become somewhat more approximated to [the position] of debenture holders*”. In view of this tendency it should be noted that the approximation could obviously not overcome the barrier of legal capital, which remains a distinct feature of a company’s share capital: Whenever a company suffers losses and has no profits available for distribution within the meaning of sec. 830, 831 CA, it is barred from paying dividends to its shareholders regardless of their preference.³¹⁴ In this respect a preference share cannot be further assimilated to debt instruments, but is destined to absorb profit shortfalls and prevent the company from running into an event of default or bankruptcy.

One of the most distinct features of Anglo-American corporate finance law and a prerequisite of locating hybrid capital in a company’s equity is its ability to redeem its share capital.³¹⁵ For accounting purposes and bank capital classification redemption is usually achieved through a call-option of the issuer.³¹⁶ A moderate³¹⁷ interest step-up aims to secure the interest of the investors to receive their investment back after a certain lapse of time – usually five to ten years.³¹⁸ Again, the rights of the hybrid investors are subject to the barrier of legal capital: redemption – at least by public companies³¹⁹ – may only be financed out of profits or proceeds from a new issue of shares. Occasionally redemption options come along with mandatory conversion provisions which provide for the conversion of the preference shares into ordinary shares in the case of financial distress and thus lead to accelerated and deeper loss absorption.

³¹³ *In Isle of Thanet Electric Co, Re* [1950] Ch. At 175.

³¹⁴ *Bishop v Smyrna and Cassaba Railway (No. 1)* [1895] 2 Ch 285; *Burland v Eagle* [1902] A.C. 83, PC; BURGESS, Corporate Finance Law, 322; DAVIES, Gower and Davies’ Principles of Modern Company Law, 825.

³¹⁵ Sec. 684(1) CA.

³¹⁶ BARDEN/MITRA/RIGELSFORD, ukGAAP 2007, 659; SINCLAIR/CRISOSTOMO, Capital Markets Law Journal Vol. 3 No. 4 2008, 458 (465). Sec. 684(1) CA.

³¹⁷ For reasons of qualification as Tier One bank capital, the step-up is restricted, see *General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms* (GENPRU) 2.2.147 R. In contrast, the *International Financial Reporting Interpretations Committee* (IFRIC) has formed the opinion that an economic compulsion is of no relevance for financial accounting equity qualification, as International Accounting Standard (IAS) 32.11 requires a purely contractual liability, see *International Accounting Standards Board* (IASB) Update June 2006.

³¹⁸ The reason is primarily related to capital adequacy requirements, see GENPRU 2.2.73 G; 2.2.153 R (1). An unspoken market rule expects the issuer to exercise the call at the first opportunity, but has recently been broken for the first time by a large bank due to higher refinancing costs, causing widespread criticism by market participants.

³¹⁹ Sec. 687 CA; private companies enjoy generous exemptions from capital maintenance restrictions for redemption purposes, sec. 709 et seq. CA. Instead of legal capital a solvency test is employed to measure redemption payments, sec. 714 CA.

(2) Hybrid Debt Securities

The design of hybrid debt securities is governed by the principle of contractual freedom, only limited by the rules of illegality, undue influence and public policy on the one hand and a few insurmountable mandatory rules of company law like the prohibition of outsider voting on the other hand. In legal practice, four criteria of capital rights are employed to approximate formal debt securities to a company's share capital: Optional interest deferral, term, ranking and conversion.

The first criterion, the discretionary deferral of interest, is achieved through linking coupon payments to distribution of profits and is a minimum requirement for the classification as Tier capital under banking regulations and as equity for financial accounting purposes.³²⁰ In order to achieve equity-likeness required for Tier One capital, the coupon is usually construed to be non-cumulative and any unpaid interest is definitively lost. Some instruments even carry a cumulative interest which is deferred to the winding up of the company, thus ranking together with the principal amount. This is one of the rare constellations that combine Tier One capital classification and tax deductibility. For the same purpose, instead of a pure interest deferral some instruments provide for *alternative coupon satisfaction mechanisms* which allow the issuer to pay the interest in the company's shares.³²¹

The indefinite term of perpetual debentures is expressly provided for in sec. 739 CA. In combination with a call-option it allows the issuer to decide on the availability of its financial resources and to structure the instrument as Tier capital and equity for accounting purposes.³²² For the same reasons the characteristics of the call-option resemble very much those accompanying redeemable shares, but – in contrast to redeemable shares – perpetual debentures may be paid back even though no profits are available.

The autonomous subordination of debt capital through contractual agreements has been subject to considerable debate for some time, but finally acknowledged in 1994 by the House of Lords.³²³ More complex types of subordination with several layers of creditors and turnover clauses often are

³²⁰ For Tier capital qualification see GENPRU 2.2.9, 2.2.11; HANNAM, *The Tax Journal* 2008, 11 August 2008, 9 (11); according to FRS 25.11 a classification as equity is only possible, if the company can avoid the delivery of cash or another financial asset, see BARDEN/MITRA/RIGELSFORD, *ukGAAP* 2007, 664.

³²¹ *Committee of European Banking Supervisors* (CEBS), Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), March 2007, 7 fn 7.

³²² CHOPPING, *Applying GAAP*, 428 f.; GENPRU 2.2.9, 2.2.11.

established by means of trust subordination.³²⁴ Such agreements allow the issuer to create a more differentiated hierarchy of claims in the case of liquidation and thus diversify the risk structure of the capital.

Convertible debt basically serves two different functions: If the exercise of the conversion right is at the option of the holder, it is treated as ordinary debt for accounting and bank capital purposes. At the same time it allows the investor to participate in the upside of the company's share value, the issuer to save liquidity through a lower coupon. If the conversion is mandatory, equity classification becomes possible, but obviously to the detriment of the risk structure of the instrument. The accounting treatment of such compound instruments has been subject to some significant changes after the introduction of FRS 25: Following IAS 32.28, convertible bonds are subject to split accounting, which requires an independent treatment of the principal amount and the conversion right.³²⁵ Under this scheme the principal amount is generally treated as debt as it constitutes a financial liability to deliver cash. Only where conversion is mandatory or at the option of the issuer the liability to deliver cash can be avoided and hence the instrument might qualify as equity.³²⁶ The conversion right of the issuer is usually treated as equity. Whether the investors hold pre-emption rights on new issues of shares depends on the type of share the debenture can be converted into: In accordance with the above mentioned³²⁷ a pre-emption right is only granted by the Companies Act, if the conversion right refers to equity share capital.³²⁸

3. Tax Treatment of Hybrid Capital in the UK

a) General Remarks

The UK tax system draws a sharp distinction between the treatment of debt and the treatment of equity.³²⁹ Interest payments on debt are usually tax deductible for the debtor and taxable in the

³²³ *British Eagle International Air Lines Ltd v Compagnie Nationale Air France* [1975] 2 ALL ER 390, HL.

³²⁴ WOOD, *Project Finance, Securitisations, Subordinated Debt*, 185, 193; FERRAN, *Company law and corporate finance*, 561.

³²⁵ FRS 25.28, in detail BARDEN/MITRA/RIGELSFORD, *ukGAAP 2007*, 666; CHOPPING, *Applying GAAP*, 429.

³²⁶ BARDEN/MITRA/RIGELSFORD, *ukGAAP 2007*, 699 et seq.

³²⁷ See page 65.

³²⁸ Sec. 560(1) CA.

³²⁹ TILEY in: GEERTEN (Ed.), *Tax Treatment of Financial Instruments*, 263 (291).

hands of the creditor. The debtor may have to withhold tax at the savings rate of income tax from the interest payment.³³⁰ The traditional distinction between income and capital gains – one of the most characteristic features of the UK tax system³³¹ – has been abandoned for corporation tax purposes. Under the loan relationship rules,³³² the tax treatment of corporate debt generally follows the accounting treatment.³³³ By contrast, dividends and other distributions are not tax deductible. The recipient of a qualifying distribution³³⁴ is entitled to a tax credit equal to one-ninth of the amount or value of the distribution.³³⁵ If the recipient is a UK resident company, the distribution is largely exempt from corporation tax.³³⁶ In this context, the distinction between income and capital gains still matters, as a gain accruing to a company on a disposal of shares in another company is only tax exempt if the much stricter requirements of the substantial shareholding exemption – contained in Schedule 7AC of the Taxation of Chargeable Gains Act 1992 (TCGA 1992) – are met.³³⁷ Finally, there is no withholding tax on dividends.³³⁸

b) Distinction between Equity and Debt

The starting point for the distinction between equity and debt for the purpose of taxation is the legal form of the financial instrument in question.³³⁹ However, the formal qualification of a financial instrument may be completely reversed depending on its accounting treatment or its underlying economic characteristics: Shareholders may be treated as creditors under the loan relationship rules; interest payments on debentures may be qualified as distribution for tax purposes. Interestingly, UK

³³⁰ Sec. 874(2) Income Tax Act 2007 (ITA 2007).

³³¹ LAUKKANEN, *Taxation of Investment Derivatives*, 148.

³³² Sec. 292-476 Corporation Tax Act 2009 (CTA 2009).

³³³ GHOSH in: HINNY (Ed.), *New tendencies in tax treatment of cross-border interest of corporations*, 735; LAUKKANEN, *Taxation of Investment Derivatives*, 148. All returns are treated as income and losses made on redemption or disposal are treated as allowable income losses. For details see HOLE, *BTR* 1995, 511 (512).

³³⁴ Sec. 14(2) Income and Corporation Taxes Act 1988 (ICTA 1988).

³³⁵ Sec. 397 Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005); sec. 231 ICTA 1988.

³³⁶ See sec. 1285 CTA 2009. As part of a larger reform of the taxation of foreign profits, the traditional exemption for UK distributions will be extended by the Finance Act 2009 to include distributions received from foreign companies. In this context, sec. 1285 CTA 2009 will be replaced by sec. 930A-930V CTA 2009.

³³⁷ Inter alia, the investing company must hold at least 10 % of the investee company's ordinary share capital and must be entitled to at least 10% of the profits and assets available for distribution. A holding of this size has to have been held throughout a continuous period of at least 12 months ending not more than one year before the disposal.

³³⁸ PENNEY in: DUNCAN (Ed.), *Tax treatment of hybrid financial instruments in cross-border transactions*, 645 (657).

³³⁹ PENNEY in: DUNCAN (Ed.), *Tax treatment of hybrid financial instruments in cross-border transactions*, 645 (646), GHOSH in: HINNY (Ed.), *New tendencies in tax treatment of cross-border interest of corporations*, 735 (736).

courts and the legislator are much more willing to re-characterise debt as equity than the other way around.³⁴⁰

The most important aspect of the classification of a financial instrument as debt or equity for taxation purposes is the nature of the return which the instrument generates. The decisive question is whether it is interest – and therefore tax deductible to the issuer – or a distribution – and therefore not tax deductible to the issuer, but tax exempt in the hands of a corporate investor. In this respect, the UK tax law is characterised by a very narrow notion of deductible interest payments. In the absence of a statutory definition, the UK courts have defined interest as “payment by time for the use of money”.³⁴¹ This means that interest is essentially calculated by reference to the time value of a certain amount of money. If the return of a financial instrument is linked to something else, it is generally not interest.³⁴² Accordingly, a payment by reference to the profits of a business is “simply a share of the profits” of the business and hence is not tax deductible.³⁴³ There is, however, one limitation on this principle which somehow marks the borderline between debt and equity for tax purposes: The fact that a payment is contingent on the profitability of the borrower does not necessarily prevent it from being qualified as interest.³⁴⁴ Interest that is only payable to the extent that the borrower has sufficient profits is qualified as tax deductible if it is cumulative, e.g. the deficiency is carried forward to be paid in later years.³⁴⁵ By contrast, a non-cumulative payment is generally not tax deductible.³⁴⁶

The scope of this jurisprudence was diminished by sec. 209(2)(e)(iii) of the Income and Corporation Taxes Act 1988 (ICTA 1988) which treats a consideration for the use of money lent to a company as a distribution if the consideration is “to any extent” dependent on the results of the company’s business. Thus, prima facie, the UK seems to have adopted a quite radical approach to the distinction between distribution and interest. It is however important to note that the impact of sec.

³⁴⁰ PENNEY in: DUNCAN (Ed.), Tax treatment of hybrid financial instruments in cross-border transactions, 645 (646).

³⁴¹ *Bennett v Ogston* [1930] 15 TC 374, 379.

³⁴² SOUTHERN/THE PRICEWATERHOUSECOOPERS FOREIGN EXCHANGE TAX TEAM, Taxation of Corporate Debt, Foreign Exchange and Derivative Contracts, 83.

³⁴³ *AW Walker & Co v IRC* [1920] 12 TC 297 (302).

³⁴⁴ NORFOLK, Taxation Treatment of Interest and Loan Relationships, 2.17.

³⁴⁵ *IRC v Pullman* [1954] 2 All ER 491, 35 TC 221; NORFOLK, Taxation Treatment of Interest an Loan Relationships, 2.17.

³⁴⁶ *IRC v Mashonaland Rly Co* [1926] 12 TC 1159; NORFOLK, Taxation Treatment of Interest an Loan Relationships, 2.18.

209(2)(e)(iii) ICTA is actually limited by a second provision which provides that the re-characterisation does not apply if the lender is a UK resident company.

The reason for the introduction of this substantial exemption was a tax avoidance scheme. Unprofitable companies, which received no immediate benefit from the deductibility of interest payments, exploited the fact that a payment was re-characterised in full if it was to any extent result-dependent.³⁴⁷ A small part of the consideration for a loan was made dependent on the results of the borrower. Consequently, a corporate lender received tax exempt distributions instead of taxable interest and was entitled to a tax credit. This tax advantage was shared between the lender and the borrower via a lower interest rate.³⁴⁸ To counter such schemes, sec. 209(2)(e)(iii) ICTA 1988 is disapplied by sec. 212 ICTA 1988 if the recipient of the payment is a company resident in the United Kingdom. In this case, the consideration is treated as a distribution only insofar as it exceeds a reasonable commercial return.³⁴⁹ However, if the lender is an individual, a partnership or a non-resident company, the basic rule still applies that a payment of interest which is to any extent dependent on the results of the borrowing company's business is qualified as distribution as a whole.

c) Tax Treatment of Hybrid Financial Instruments in a National Context

aa) Hybrid Equity Securities

As mentioned before, preference and redeemable shares are the predominant form of hybrid equity securities in the UK. Even though it is possible to design redeemable preference shares in a way that economically mimics a lending transaction, the tax treatment of these shares follows their legal form to a large extent. Where corporate law calls something a share, it is generally accepted as such for UK tax purposes.³⁵⁰ As a result, the tax treatment of preference and redeemable shares does generally not differ from the tax treatment of ordinary shares.³⁵¹

³⁴⁷ TILEY, Revenue Law, 855.

³⁴⁸ TILEY in: GEERTEN (Ed.), Tax Treatment of Financial Instruments, 263 (294).

³⁴⁹ TILEY, Revenue Law, 855.

³⁵⁰ PENNEY in: DUNCAN (Ed.), Tax treatment of hybrid financial instruments in cross-border transactions, 645 (646). See also *HSBC Life v Stubbs* [2002] STC (SCD) 9, para 71: "The mere economic equivalence of a transaction to loan does not show that it is a loan."

³⁵¹ Dividends paid on preference or redeemable shares are exempt from corporation tax and the substantial shareholding exemption applies to disposals of preference shares.

However, there are limits to the respect of form in the UK tax system. Under the “shares as debt” rules as well as under the new “shares accounted for as liabilities rules”,³⁵² redeemable preference shares which are designed to yield an interest-like return are – if further specific conditions are met – treated as creditor loan relationships for taxation purposes. It is important to note that the scope of this anti-avoidance legislation is quite limited. It covers only quasi-loans that are treated as financial liability rather than equity for accounting purposes, and the generation of a tax advantage must be one of the main purposes of the investment. This leaves plenty of room for schemes which come very close to lending transactions in their economic substance without there being a risk of re-characterisation.

bb) Hybrid Debt Securities

Only three of the four above mentioned criteria of capital rights that are used to approximate formal debt securities to equity are relevant for tax purposes.

The ranking of debt does not affect its tax treatment. From the perspective of the UK tax system, a creditor who is subordinated in that he is to be paid only after other creditors are satisfied remains nevertheless a creditor and is taxed accordingly.³⁵³

Similarly, the term of debt does not – at least in national tax context – lead to a re-characterisation. Even perpetual debt is traditionally qualified as debt for tax purposes. This has caused problems in cross-border situations which will be described below.

Perpetual bonds with the option to defer coupon payments are used by banks in order to raise tax deductible Tier One capital. An important requirement for Tier One capital is the bank’s ability to suspend interest payments in case of financial difficulties.³⁵⁴ This is problematic because of sec. 209(2)(e)(iii) ICTA 1988. While a cumulative coupon will generally be accepted as tax deductible, a non-cumulative coupon could be classified as distribution because of its result-dependency unless the lender is a company which is within the charge to corporation tax.³⁵⁵ How-

³⁵² The “shares accounted for as liabilities rules” are part of the Finance Bill 2009 and will replace “shares as debt” – contained in sec. 91A-91G Finance Act 1996 – with effect from 22 April 2009. The “shares accounted for as liabilities” rules will become sec. 521A-521F CTA 2009.

³⁵³ TILEY in: GEERTEN (Ed.), *Tax Treatment of Financial Instruments*, 263 (309).

³⁵⁴ HANNAM, *The Tax Journal* 2008, 11 August 2008, 9 (10).

³⁵⁵ Sec. 212 ICTA 1988.

ever, HM Revenue & Customs denies result-dependency – and therefore allows for tax deduction – if the coupon is deferred until the winding up of the bank.³⁵⁶ This is surely the ultimate example of a cumulative coupon.

The tax treatment of issuers and corporate holders of convertible bonds follows the accounting treatment of these instruments. This means that for tax purposes convertible bonds are bifurcated into the debt component and the equity component. The debt component is taxed as if it was an ordinary loan relationship.³⁵⁷ The equity component, i.e. the right to convert the bond into shares, is taxed like an independent derivative contract.³⁵⁸ As a result, interest payments on convertible bonds are generally tax deductible. There is, however, one exception: If a convertible bond is not quoted on a recognised stock exchange nor issued on terms which are reasonably comparable with terms of issue of bonds quoted on a recognised stock exchange, interest payments are classified as distribution under sec. 209(2)(e)(ii) ICTA 1988.³⁵⁹

d) Tax Treatment of Hybrid Financial Instruments in Cross-Border Transactions

In a cross-border context, hybrid financial instruments have been used for many years to arbitrage a mismatched tax treatment in the jurisdictions of the issuer and the investor. In the UK there is therefore a long history of specific legislation designed to remove the arbitrage benefits available from certain instruments.³⁶⁰

In the case of a UK resident issuer and a non-UK resident investor, a tax advantage may be obtained by the use of hybrid financial instruments that are classified as debt in the UK and as equity in the investor's jurisdiction. As a result of this classification mismatch, the return of the financial instrument will generally be tax deductible in the UK and tax exempt in the hands of the investor.

For example, US multinationals exploited the fact that perpetual bonds were classified as debt in the UK and as equity in the US and used such instruments as a tax effective way of funding their UK

³⁵⁶ HANNAM, *The Tax Journal* 2008, 11 August 2008, 9 (10).

³⁵⁷ Sec. 415 CTA 2009.

³⁵⁸ Sec. 585 CTA 2009.

³⁵⁹ Sec. 209(2)(e)(ii) ICTA 1988 is disapplied by sec. 212 ICTA 1988 if the recipient of the payment is a company which is within the charge to corporation tax.

³⁶⁰ PENNEY in: DUNCAN (Ed.), *Tax treatment of hybrid financial instruments in cross-border transactions*, 645.

subsidiaries.³⁶¹ This led to the introduction of sec. 209(2)(e)(vii) ICTA 1988 which provides, generally speaking, that interest payments will be classified as distributions for tax purposes if equity notes – defined as securities which are not redeemable within 50 years from the date of issue – are issued by a 75 %-subsidiary of the investing company.³⁶²

At first sight, this legislation seems to draw no distinction between national and cross-border transactions. Prima facie, the classification of interest as distribution under sec. 209(2)(e)(vii) ICTA 1988 applies regardless of the residence of the recipient.

However, – as in the above-mentioned cases of result-dependency or certain convertible bonds³⁶³ – sec. 212 ICTA 1988 provides – if the recipient is a UK resident company – that interest payments on equity notes are only re-characterised as distributions insofar as they exceed a reasonable commercial return. This means that – in the context of corporation tax – the classification of the return of certain hybrid debt securities as distribution under sec. 209(e)(2) ICTA 1988 applies primarily to cross-border transactions.

Finally it shall be noted that special anti-avoidance rules targeted at international tax arbitrage through hybrid financial instruments are contained in Finance (No. 2) Act 2005, sec. 24-37 and Schedule 3. UK corporation tax relief is denied under these rules if the main purpose or one of the main purposes of the use of such instruments is to obtain a UK tax advantage.³⁶⁴

VI. United States

1. Corporate Law

In the U.S., corporate law is mostly created by the states.³⁶⁵ It is, however, subject to intrusions by federal law, namely in the area of securities and – even more important for this analysis – in the event of bankruptcy. Besides taxation, the latter is the field in which the search for the demarcation line between equity and debt takes place. By means of the doctrine of debt re-characterisation fed-

³⁶¹ PENNEY in: DUNCAN (Ed.), Tax treatment of hybrid financial instruments in cross-border transactions, 645.

³⁶² For further details of this legislation see TILEY, Revenue Law, 856.

³⁶³ Sec. 209(2)(e)(ii), (iii) ICTA 1988.

³⁶⁴ GHOSH in: HINNY (Ed.), New tendencies in tax treatment of cross-border interest of corporations, 735 (738).

³⁶⁵ LUCIAN A. BEBCHUK, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435, 1442 (1992); ROBERTA ROMANO, The genius of American corporate law (1993), 1.

eral bankruptcy courts make judgments on the nature of corporate financing instruments.³⁶⁶ It is often related but not necessarily limited to corporate insiders. Furthermore, re-characterisation of debt as equity might also be available in other corporate law areas and before state courts.³⁶⁷

Thus, in the U.S., no level playing field for corporate finance exists. Characterisation of financial instruments is not only subject to varying state regulation but also to a mixture of federal precedents. Despite the legal variety in detail, common principles exist. Among these is an extensive flexibility to tailor corporate statutes – especially in comparison to German law. The same holds true for corporate finance which results in a vast number of financial instruments combining aspects of equity, e.g. participation in firm governance and performance, with those of debt, e.g. preferred payment in case of insolvency. The possibility to generate arbitrarily any kind of hybrid instrument, “a continuum between debt and equity”,³⁶⁸ renders a general classification of instruments into equity and debt almost impossible.³⁶⁹ The distinction is rather made on a case-by-case basis. Therefore, courts usually evaluate a number of criteria with no fixed primacy for certain factors.³⁷⁰ The courts’ aim is to figure out the parties’ intent from the wording in the contract, the actual transactions, and the surrounding economic reality.³⁷¹

To characterise an instrument as debt or equity the *Court of Appeals for the Sixth Circuit in re Autostyle Plastics* – quite surprisingly – refers to the factors of the *Roth Steel Tube Co. v. Commissioner of Internal Revenue*³⁷² decision concerning tax issues.³⁷³ This mostly cited eleven-factor test takes into account:

(1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and in-

³⁶⁶ In re *Georgetown Bldg. Associates, Ltd. Partnership*, 240 B.R. 124, 137 (Bankr. D. D.C. 1999).

³⁶⁷ MONTE GRAY, *Recharacterizing Debt to Equity – Not Just For Bankruptcy*, 50 *The Advocate* (Idaho) 22, 23 (2007).

³⁶⁸ JAMES W. MILTON and STEPHEN MOELLER-SALLY, *Debt Recharacterization Under State Law*, 62 *Bus. Law.* 1257, 1262 et seq. (2006-2007).

³⁶⁹ WILLIAM J. RENDS, *The Closely Held Corporation: Its Capital Structure and The Federal Tax Laws*, 90 *W. Va. L. Rev.* 1009, 1017 et seq.

³⁷⁰ In re *Autostyle Plastics*, 269 F.3d 726, 730 (6th Cir 2001).

³⁷¹ In re *SubMicron Sys.*, 432 F.3d 448, 456 (3rd Cir. 2006) ; In re *Autostyle Plastics* (Note 370), at 738.

³⁷² *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625 (6th Cir. 1986).

³⁷³ In re *Autostyle Plastics* (Note 370), at 729 et seq.

terest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalisation; (6) the identity of interest between creditor and stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.³⁷⁴

Even though most federal (and state)³⁷⁵ courts use a multi-factor test usually based on the aforementioned or similar criteria,³⁷⁶ the *Courts of Appeals for the Fourth and Third Circuit* emphasise that in distinguishing debt from equity “no mechanistic scorecard suffices”³⁷⁷. The latter rather relies on a “common-sense conclusion” whether the party acted as a banker expecting fixed repayment and interest or as an investor participating in the company's fortune.³⁷⁸

2. Tax Law

a) Domestic Federal Tax Law

Due to significant differences in the respective tax treatment the distinction of debt and equity is of particular importance in the area of taxation. Under U.S. tax law a corporation may not deduct dividends paid to its shareholders as consideration for the provision of equity. At the same time, however, it may deduct all interest paid on debt³⁷⁹. The investor has to include both dividends and interest received in his annual tax return.³⁸⁰ Only dividends are subject to the reduced tax rate of 15% for capital gains.³⁸¹ Corporations may, moreover, deduct 70% or even 100% of dividends received if both entities are members of the same affiliated group (*dividends received deduction*).³⁸²

³⁷⁴ *Roth Steel Tube Co. v. Comm'r* (Note 372), at 630.

³⁷⁵ See e.g. *Tanzi v. Fiberglass Swimming Pool*, 414 A.2d 484, 490 (RI 1980).

³⁷⁶ JOAN N. FEENEY, *Bankruptcy Law Manual* § 11 A: 32 (June 2009).

³⁷⁷ *In re Official Committee of unsecured Creditors for Dornier Aviation*, 453 F.3d 225, 227 (4th Cir. 2006); *In re SubMicron Sys.* (Note 371), at 456.

³⁷⁸ *In re SubMicron Sys.* (Note 371), at 456.

³⁷⁹ Sec. 163 (a)(4) IRC.

³⁸⁰ Sec. 61 (a) (4) and (7) IRC.

³⁸¹ Sec. 1 (h) (11) IRC.

³⁸² Sec. 243 IRC.

aa) Multi-Factor Approach under Case Law

Due to the lack of statutory or regulatory definitions of debt and equity American courts have developed a multi-factor test under which an instrument qualifies as either debt or equity (*all-or-nothing approach*).³⁸³ Only in two cases courts have applied a different approach by treating some of an instrument's components as equity and, at the same time, others as debt (*bifurcation*).³⁸⁴

The basic idea of the governing case law is the notion of the shareholder as “an adventurer in the corporate business” who “takes the risk, and profit from success.” In contrast, the creditor, “in compensation for not sharing the profits, is to be paid independently of the risk of success.”³⁸⁵ Therefore, the economic reality of a financial instrument shall prevail over the form chosen by the parties (*substance over form*).³⁸⁶ According to the courts, the analysis and weighing of the factors always depends on the facts and circumstances of each case.³⁸⁷ The number of factors applied varies significantly. While courts usually apply 11 to 16 factors³⁸⁸, academic writers have identified up to 38 different factors³⁸⁹. To date, the U.S. Supreme Court has handed down only one decision regarding the debt-equity issue by merely stating that no one factor is decisive in the determination of whether an investment is equity or debt.³⁹⁰

Early cases stress the intent of the parties to create a debtor-creditor relationship or rather a corporation-shareholder relationship as a factor of importance for the distinction of debt and equity.³⁹¹ Among the aspects considered are the name given to the instrument³⁹² and the treatment of the instrument on the parties' balance sheets³⁹³. Even though later cases have not abandoned intent as a

³⁸³ H.R. Rep. 102-716 (July 24, 1992), p. 3.

³⁸⁴ *Richmond, Fredericksburg & Potomac R.R. Co. v. Comm'r*, 528 F.2d 917 (4th Cir. 1987); *Farley Realty Corporation v. C.I.R.*, 279 F.2d 701, 704 (2nd Cir. 1960).

³⁸⁵ *C.I.R. v. O.P.P. Holding Corp.*, 76 F.2d 11, 12 (2nd Cir. 1935).

³⁸⁶ *Monon Railroad v. Comm'r*, 55 T.C. 345, 357 (1970); *Gregory v. Helvering*, 293 U.S. 465, 470 (1935).

³⁸⁷ *Monon Railroad v. Comm'r* (Note 386), at 356; Rev. Rul. 85-119 (July 1985), p. 5.

³⁸⁸ *Roth Steel Tube Co. v. Comm'r* (Note 372), at 630; *Fin Hay Realty Co. v. U. S.*, 398 F.2d 694, 696 (3rd Cir. 1968).

³⁸⁹ See WILLIAM T. PLUMB, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 407 (1971).

³⁹⁰ *John Kelley Co. v. Comm'r*, 326 U.S. 521, 530 (1946); Rev. Rul. 68-54 (January 16, 1968), p. 4.

³⁹¹ *Bowersock Mills & Power Co. v. Comm'r*, 172 F.2d 904, 907 (10th Cir. 1949); *U.S. v. Title Guarantee & Trust Co.*, 133 F.2d 990, 993 (6th Cir. 1943).

³⁹² *Fin Hay Realty Co. v. U.S.* (Note 388), at 697; *Monon Railroad v. Comm'r* (Note 386), at 356 et seq.

³⁹³ *Roth Steel Tube Co. v. Comm'r* (Note 372), at 630; PLUMB (Note 389), at 405.

factor for the identification of debt and equity³⁹⁴ the focus has shifted towards an analysis of the investor's rights and risks under the terms of the instrument scrutinised.³⁹⁵ The most crucial factor for the distinction of debt and equity thus seems to be the existence of a fixed maturity date.³⁹⁶ As long as other factors do not point towards debt, the lack of a fixed maturity date will indicate equity.³⁹⁷ Another important factor is the determination and amount of interest paid as consideration for the provision of capital. An unconditionally payable and enforceable fixed interest rate supports the conclusion of debt³⁹⁸ while any payment dependent upon the earnings³⁹⁹ or the discretion of the organisation's board of directors⁴⁰⁰ indicates equity. Other often considered factors include the participation of the investor in the success of the venture and the risk involved regarding the repayment of the principal.⁴⁰¹ Another factor adverse to debt classification is subordination.⁴⁰²

Of rather minor importance for the debt-equity issue is the existence and extent of voting rights or participation in management.⁴⁰³ Even the complete lack of voting and management rights does not support debt classification.⁴⁰⁴ However, identity of shareholders and creditors can indicate equity.⁴⁰⁵

bb) Statutory Responses

To date, the U.S. Congress has not codified a method for the proper distinction of debt and equity.⁴⁰⁶ However, in 1969 it introduced legislation under which the U.S. Treasury is authorised to

³⁹⁴ See *Slappey Drive Indus. Park v. U.S.*, 561 F.2d 572, 582 (5th Cir. 1977).

³⁹⁵ *Fin Hay Realty Co. v. U.S.* (Note 388), at 697; *Nestle Holdings Inc. v. Comm'r*, T.C.Memo1995-441, 68 (1995).

³⁹⁶ *Roth Steel Tube Co. v. Comm'r* (Note 372), at 630; *Fin Hay Realty Co. v. U.S.* (Note 388), at 696; BORIS I. BITTKER and JAMES S. EUSTICE, *Federal Income Taxation of Corporations and Shareholders* (2005) ¶ 4.03 [2] [b]; ROGER B. MADISON, *The Deductibility of "Interest" on Hybrid Securities*, 39 *Tax Law.* 465, 474 (1986); IRS Notice 94-47 (January 1994), 1994-19 I.R.B. 9.

³⁹⁷ *Monon Railroad v. Comm'r* (Note 386); at 359; *John Kelley Co. v. Comm'r* (Note 390), at 526.

³⁹⁸ *John Kelley Co. v. Comm'r* (Note 390), at 526.

³⁹⁹ MADISON (Note 396), at 475 et seq.

⁴⁰⁰ PLUMB (Note 389), at 406, 430 et seq.

⁴⁰¹ *Fin Hay Realty Co. v. U.S.* (Note 388), at 696.

⁴⁰² *Fin Hay Realty Co. v. U.S.* (Note 388), at 696; *John Kelley Co. v. Comm'r* (Note 390), at 526; BITTKER/EUSTICE (Note 396), at ¶ 4.03 [2] [d]; PLUMB (Note 389), at 406, 421 et seq.

⁴⁰³ BITTKER/EUSTICE (Note 396), at ¶ 4.03 [2] [h]; MADISON (Note 396), at 478.

⁴⁰⁴ *John Kelley Co. v. Comm'r* (Note 390), at 530; PLUMB (Note 389), at 447 et seq.

⁴⁰⁵ *Roth Steel Tube Co. v. Comm'r* (Note 372), at 630; *Fin Hay Realty Co. v. U.S.* (Note 388); at 696.

⁴⁰⁶ S. Rep. 83-1622 (April 5, 1954), p. 4673: "[A]ny attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments".

prescribe regulations for the distinction of stock and indebtedness.⁴⁰⁷ According to statutory law, these regulations shall set forth factors to be taken into account in determining whether a debtor-creditor relationship or a corporation-shareholder relationship exists. As non-binding examples the provision lists five of the factors developed under case law (fixed maturity and interest rate, subordination, ratio of debt to equity, convertibility into stock, and the relationship between holdings of stock in the corporation and holdings of the interest in question). In 1980, the Treasury made use of its authorisation and issued extensive regulations for the distinction of debt and equity⁴⁰⁸ which were criticised as overly complex and impractical but not comprehensive.⁴⁰⁹ Due to the Treasury's concerns regarding possible abuses of the regulations by innovative financial engineers they were withdrawn in 1983.⁴¹⁰ Since then there has been not a single attempt to issue new regulations even though the Treasury's authorisation was amended in 1989 to include rules regarding bifurcation of financial instruments.

After the failure of the regulations, Congress concluded that a comprehensive legislative solution to the debt-equity issue was impossible and shifted to the implementation of specific provisions in order to avoid certain transactions considered abusive.⁴¹¹ For example, since 1989, special rules apply to bonds that mature not earlier than five years after issuance if the yield at maturity exceeds the sum of the applicable Federal rate plus five percentage points and if such instrument has significant original issue discount.⁴¹² Under general rules of tax law, an original issue discount need not be deducted in the fiscal year in which the repayment takes place but may be split into equal annual deductions throughout the life of the instrument.⁴¹³ In 1989, Congress excluded applicable high yield discount obligations from this favourable rule and limited them to deduction after repayment of the principal.⁴¹⁴ Moreover, the provision permanently disallows the deduction of any portion of

⁴⁰⁷ Sec. 385 IRC.

⁴⁰⁸ T.D. 7747, 45 FR 86438 (Dec. 31, 1980).

⁴⁰⁹ ADAM O. EMMERICH, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, 52 U. Chicago L. Rev. 118, 129 (1985).

⁴¹⁰ T.D. 7920, 48 FR 50711 (Nov. 3, 1983); earlier modified by T.D. 7774, 46 FR 24945 (May 4, 1981); T.D. 7801, 47 FR 147 (Jan. 5, 1982) and T.D. 7822, 47 FR 28915 (July 2, 1982).

⁴¹¹ BITTKER/EUSTICE (Note 396), at ¶ 4.02[8][b].

⁴¹² Sec. 163 (e) (5) IRC (“*applicable high yield discount obligation*”).

⁴¹³ DANIEL I. HALPERIN, Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation, 95 Yale L. J. 506, 509 et seq. (1986).

⁴¹⁴ Sec. 163 (e) (5) (A) (ii) IRC.

the original issue discount that exceeds the applicable Federal rate by more than six percentage points.⁴¹⁵ The provision thus employs a partial bifurcation approach with a very narrow scope.⁴¹⁶

Another example is the consistency rule⁴¹⁷ of 1992. Under this rule, the issuer's characterisation of an instrument as debt or equity is binding on the issuer and all holders of such instrument but not on the IRS.⁴¹⁸ The provision serves to preclude the issuer from deducting the interest paid on an instrument while the holder benefits from the dividends received deduction.⁴¹⁹ The holder may still depart from the issuer's characterisation if he discloses this inconsistent treatment in his tax return. The applicability of this rule to hybrid instruments is arguable since they are typically treated by the issuer as stock for some purposes (e.g. accounting, rating)⁴²⁰ and as debt for others (e.g. taxation).⁴²¹ Thus, his characterisation will often be ambiguous and will therefore not satisfy the clear characterisation requirement of the statute.

Moreover, in 1997, the Congress enacted legislation in order to bar the interest deduction for certain instruments with extensive equity characteristics.⁴²² The provision applies to instruments that require or entitle the debtor to discharge his contractual payment obligations by the transfer of equity of the issuer or a related party. It also applies if a substantial amount of the principal or interest is determined by reference to the value of the equity of the issuer.

cc) Selected Revenue Rulings of the Internal Revenue Service (IRS)

(1) Adjustable Rate Convertible Note (ARCN)

⁴¹⁵ Sec. 163 (e) (5) (A) (i) IRC.

⁴¹⁶ BITKER/EUSTICE (Note 396), at ¶ 4.03[6].

⁴¹⁷ Sec. 385 (c) IRC.

⁴¹⁸ DANIEL M. BERMAN and DENISE O. STRAIN, Tax treatment of hybrid financial instruments in cross-border transactions: United States National Report, Cahiers de droit fiscal international, CDFI 85a (2000), p. 677.

⁴¹⁹ H.R. Rep. 102-716 (July 24, 1992), p. 3.

⁴²⁰ Notice 94-47 (January 1994), 1994-19 I.R.B. 9.

⁴²¹ BERMAN/STRAIN (Note 418), at 676.

⁴²² Sec. 163 (l) IRC.

In 1983, the IRS ruled that subordinated adjustable rate convertible notes under certain circumstances were to be treated as equity.⁴²³ The notes matured after 20 years and were issued at a principal of US\$ 1,000 being equal to the value of 50 shares of issuer's common stock at the time of issuance. On maturity the holders were entitled to elect to receive either US\$ 600 in cash or 50 shares of issuer's stock. Each ARCEN was convertible at any time into 50 shares of issuer's stock. From two years after issuance on the issuer had the right to call any ARCEN at a price of US\$ 600. Upon call, the holder could exercise his right to conversion. Interest equalled the dividends paid on 50 shares of issuer's stock plus an amount equal to 2% of the principal. However, such payments may not be less than US\$ 60 or more than US\$ 175 per ARCEN.

The IRS stressed that the holders' right to elect cash payment in most circumstances would be detrimental to the holders since the repayment amount was significantly below the issue price. Thus, in most circumstances – including the anticipated development of the stock market – holders would exercise their right to conversion in order to avoid losing US\$ 400 on the principal. Moreover, by calling an ARCEN at the price of US\$ 600 before maturity the issuer could force conversion because payment in cash will most likely be disadvantageous for the investor. The economic risk of the stock market development was thus almost completely imposed on the investor who therefore closely resembled any shareholder of the issuer.

Another factor considered was that interest depended on the success of the issuer's business. The IRS emphasised that the annual minimum interest of US\$ 60 was unreasonably low in comparison to the annual return on comparable nonconvertible, non-contingent instruments. Therefore, the ARCEN did not have a fixed interest rate indicating debt but more than 65% of its future annual yield depended on the discretion of the issuer regarding the dividends paid.

(2) Convertible Debentures

In 1985, the IRS allowed deduction of interest on a subordinated convertible debenture which was payable at maturity in common or, at the option of the issuer, preferred stock.⁴²⁴ In its ruling the

⁴²³ Rev. Rul. 83-98 (July 1983).

⁴²⁴ Rev. Rul. 85-119 (July 1985), 1985-30 I.R.B. 21.

IRS emphasised that convertibility generally supports equity classification but in this case was compensated by two conflicting factors strongly indicating debt treatment: First, the number of shares to be transferred upon the investor at maturity was not fixed but depended on the principal and the market rate of issuer's stock at maturity. Therefore, the investor did not participate in stock market developments during the life of the instrument but received merely the number of shares necessary to accomplish repayment of the principal at the market rate of the issuer's stock given at maturity. Second, every investor was entitled to opt for repayment of the principal in cash without carrying the burden, cost, and risk of the sale of his stock which was to be carried out by the issuer on his behalf. Failure of the issuer to perform on its duty to sell sufficient stock and to deliver cash equal to the principal amount would provide the investor with a cause of action for money damages.

b) International Taxation

aa) General Aspects

Hybrid instruments may be characterised as debt in one country and equity in another. Opportunities for international tax arbitrage exist where a hybrid gives rise to an interest deduction in one country while the item received is classified as a dividend subject to preferential tax treatment in the other country. There is a variety of techniques for creating instruments that fall on one side of the debt-equity continuum for U.S. purposes but on the other side for foreign purposes. A widely used technique for obtaining disparate tax treatment is to create an instrument characterised as debt under the substance-over-form doctrine in the U.S. while it is classified as equity in a foreign jurisdiction respecting the form of the transaction.⁴²⁵ The consistency rule mandating that the issuer's characterisation of an instrument is binding on all holders of the instrument is not applicable to cross-border transactions.⁴²⁶ However, in order to avoid being barred from invoking the substance-over-

⁴²⁵ GREGG D. LEMEIN and JOHN D. McDONALD, Cross-Border Hybrid Instruments, 79 *Taxes* 5, 6 (Nov. 2001); JASON G. SULLIVAN, Debt-Equity Hybrid Instruments in a Cross-Border Setting: A Focus on the U.S. Foreign Tax Credit, 53 *Tax Notes Int'l* 817, 823 (2009).

⁴²⁶ TAM 200419001 (May 7, 2004); PHILIP R. WEST, Foreign Law in U.S. International Taxation: The Search for Standards, 3 *Fla. Tax Rev.* 147, 182 FN 119 (1996).

form doctrine under case law principles⁴²⁷ the taxpayer has to ensure that he treats the instrument consistently on his U.S. tax returns⁴²⁸ and that an analysis of the debt-equity factors points in the direction of the desired characterisation.⁴²⁹

bb) U.S. International Tax Law

(1) Taxation of Foreign Persons

Foreign persons are taxed at a flat rate of 30 % on the gross amount of their U.S. source investment income, including interest and dividends, not effectively connected with the conduct of a trade or business in the U.S.⁴³⁰ As a general rule interest and dividends from a domestic corporation are treated as U.S. source income.⁴³¹ The flat tax is enforced by withholding at source.⁴³² In 1984, Congress repealed the 30 % tax on *portfolio interest* received by foreign taxpayers from U.S. sources.⁴³³ Portfolio interest is interest paid to an unrelated passive investor who is verifiably a foreign person.⁴³⁴ Interest paid to a recipient who owns 10 % or more of the total voting stock of the payer does not qualify as portfolio interest. In addition, the portfolio interest exemption does not apply to *contingent interest*, the amount of which is determined by reference to (a) any receipts, sales or other cash flow, (b) any income or profits, (c) any change in value of any property, or (d) any dividend, partnership distributions, or similar payments made by the debtor or a related person.⁴³⁵ However, interest is not contingent solely by reason of the fact that (i) the timing of interest or principal payment is subject to a contingency, (ii) the interest is paid with respect to non-recourse or limited recourse indebtedness, (iii) the interest is determined by reference to non-contingent interest (or to

⁴²⁷ *Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974); *Comm'r v. Danielson*, 378 F.2d 771, 775 (3rd Cir. 1967) (taxpayer may not disavow its chosen form unless it can show mistake, fraud, undue influence, or duress); *Elrod v. C.I.R.*, 87 T.C. 1046, 1065-66 (1986) (taxpayer has to present "strong proof" that the terms of the written instrument do not reflect the actual intentions of the contracting parties).

⁴²⁸ TAM 200418008 (Dec. 29, 2003).

⁴²⁹ LEMEIN/MCDONALD (Note 425), at 8; SULLIVAN (Note 425), at 823.

⁴³⁰ Secs. 871(a)(1)(A) and 881(a)(1) IRC.

⁴³¹ Secs. 861(a)(1)(A) and (a)(2)(A) IRC.

⁴³² Secs. 1441(a) and 1442(a) IRC.

⁴³³ Secs. 871(h), 881(c) IRC.

⁴³⁴ BORIS I. BITTKER and LAWRENCE LOKKEN, *Federal Taxation of Income, Estates and Gifts*, ¶ 67.2.2 [2]; JOSEPH ISENBERGH, *International Taxation*, Second Edition 2005, 82 et seqq.

⁴³⁵ Secs. 871(h)(4)(A), 881(c)(4) IRC.

the principal amount on which such other interest is paid), (iv) the debtor or a related person enters into a hedging transaction to manage the risk of interest rate or currency fluctuations with respect to such interest, or (v) the interest is determined by reference to changes in the value or yield on actively traded property (other than debt instruments paying contingent interest or stock or other property that represents a beneficial interest in the debtor or a related person).⁴³⁶ Contingent interest was excluded from the portfolio interest exemption in 1993 because Congress was concerned that the broad exemption would give foreign investors an incentive to structure U.S. equity investments in a way that returns therefrom would be characterised as interest income, as opposed to otherwise taxable forms of income.⁴³⁷

(2) Taxation of Foreign Income

The United States taxes its citizens, resident aliens, and domestic corporations on their worldwide income. In order to eliminate double taxation where a U.S. person is taxed by a foreign source country domestic tax law grants the taxpayer a credit for income taxes paid to the foreign country.⁴³⁸ In addition, a domestic corporation that owns at least 10 % of the voting stock in a foreign corporation from which it receives a dividend is treated as having paid foreign income taxes actually paid by its subsidiary. The total amount of the direct and indirect foreign tax credit is limited by the amount of U.S. income tax on the foreign source income. Where reference is made to foreign income or foreign earnings for purposes of calculating the amount of indirect foreign tax credit or the tax credit limitation tax provisions generally incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control.⁴³⁹

cc) U.S. Tax Treaties

⁴³⁶ Sec. 871(h)(4)(C) IRC.

⁴³⁷ H.R. Rep. 103-111 (May 25, 1993), p. 726 et seq.

⁴³⁸ Secs. 901 - 908 IRC.

⁴³⁹ *Biddle v. Comm'r*, 302 U.S. 573, 578 (1938); *Goodyear Tire & Rubber Co. v. Comm'r*, 493 U.S. 132, 145 (1989).

The U.S. has an extensive network of tax treaties with other countries to avoid double taxation and prevent tax evasion. Domestic tax law is to be applied to a taxpayer with due regard to U.S. treaty obligations.⁴⁴⁰

(1) Defining Dividends and Interest

Art. 10 (5) of the U.S. model income tax convention (U.S. model) defines *dividends* as income from shares or other rights - not being debt claims - participating in profits, as well as income that is subjected to the same tax treatment as income from shares under the laws of the source state. The broad and flexible definition of the term dividends is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the source country.⁴⁴¹

Art. 11 (3) U.S. model employs a two-part definition of the term *interest*. The first part autonomously defines interest as income from debt claims of every kind, including debt obligations carrying the right to participate in profits. In addition interest also includes amounts subject to the same tax treatment as income from money lent under the law of the state in which the income arises. However, the term interest does not include amounts that are treated as dividends under Art. 10 U.S. model treaty.

(2) Assignment of Taxing Jurisdiction

Consistent with the prevailing consensus among industrialised countries the U.S. model assigns primary jurisdiction to tax dividends to the residence country reducing the source state's tax jurisdiction to 15 % (*portfolio dividends*) or 5 % (*direct investment*). Jurisdiction to tax interest income is exclusively assigned to the residence country. The United States has adopted different policies in assigning tax jurisdiction for payments on hybrid instruments to the source and residence state.

Art. 11 (2) U.S. model repeals the exclusive assignment of tax jurisdiction to the residence state for interest determined with reference to receipts, sales, income, profits or other cash flows of the

⁴⁴⁰ Sec. 894(a)(1) IRC.

⁴⁴¹ Art. 10 para. 5 TE U.S. model.

debtor. The provision which mirrors the exclusion of contingent interest from the portfolio interest exemption preserves taxing jurisdiction of the source state for certain equity-flavoured debt instruments.⁴⁴² However, the tax rate in the source state may not exceed 15 %. Provisions similar to Art.11 (2) U.S. model have been adopted in tax treaties with Austria, France, and the U.K. The treaty with Switzerland provides for an unlimited tax jurisdiction as to contingent interest arising in the U.S. without reserving a corresponding right to tax such interest arising in Switzerland.⁴⁴³

Under a different approach the scope of the dividend definition is extended to include debt obligations carrying the right to participate in profits. This approach has been adopted in the tax treaty with the Netherlands for income from sources within the U.S.⁴⁴⁴ Treating participating debt as equity allows a bright-line debt-equity distinction for treaty purposes which has, in contrast to the lack of clarity under domestic law, the advantage of administrative efficiency.⁴⁴⁵ A variation of this approach has been adopted in tax treaties with Austria and France. These treaties provide for a broad dividend definition including income from participating debt obligations, though only to the extent so characterised under the law of the source state.⁴⁴⁶

A third approach, taken in the tax treaty with Germany, reserves unlimited taxing jurisdiction of the source state for income that is (i) from an arrangement carrying the right to participate in profits, including contingent interest that would not qualify as portfolio interest in the U.S., and (ii) is deductible in determining the profits of the payer.⁴⁴⁷

C. Analysis

I. The Relevance of Corporate Law

⁴⁴² ISENBERGH (Note 434), at 257.

⁴⁴³ Art. 11 (6) U.S./Switzerland Income Tax Treaty.

⁴⁴⁴ Art. 10 (6) U.S./Netherlands Income Tax Treaty.

⁴⁴⁵ ERIC M. OVERMAN, *The U.S.-Netherlands Tax Treaty: Important Changes, Practitioner's Response, and Primary Effects*, 48 *Tax Law* 207, 210 (1995).

⁴⁴⁶ Art. 10 (3) U.S./Austria Income Tax Treaty; Art. 10 (5) (a) U.S./France Income Tax Treaty.

⁴⁴⁷ Art. 10 (6) U.S./Germany Income Tax Treaty.

Corporate law and adjacent fields of private law like civil law, insolvency law, accounting law etc. play a major role when it comes to the characterisation of a financial instrument as debt or equity in the context of income taxation. But this self-evident statement comes with a caveat: one has to distinguish between the components of a financial instrument under corporate and contract law on the one hand and the labeling of a financial instrument under corporate and accounting law on the other hand. While everyone will accept that the correct tax treatment depends on the particular legal features of a given instrument and their respective role for income taxation it is by no means evident that the overall qualification of a financial instrument as debt or equity automatically triggers an analogous qualification under tax law.

Moreover it should be accepted that the labeling of debt and equity under civil and corporate law refers to quite different topics where quite diverse conflicts have to be resolved. In corporate law, the distinction between debt and equity focuses on topics like “legal capital” or “voting rights”. In accounting law, the distinction between debt and equity is employed to inform the general public about different kinds of stakeholders in a company, including the different risks they are bearing. In insolvency law, the distinction between debt and equity proves decisive for the rank and participation of the financier in the liquidation proceeds. It is evident that every single topic requires separate consideration. Thus, a shareholder loan might be a debt claim from the point of view of contract and corporate law while it can be regarded as equity under insolvency law under certain requirements. It should be even more evident that the distinction between equity and debt under civil law in general does not automatically trigger certain tax consequences so far.

Moreover, the concepts of debt and equity differ substantially under corporate law when we take a closer look at the comparative perspective laid out in the preceding national reports.

- Basically, there are jurisdictions where formal elements play a decisive role while other jurisdictions tend to prefer a “substance over form” approach. France stands out for a formal perspective. Here, the dividing line between shares and obligations, tracing back to the formation of a financial instrument either under corporate law or under contract law respectively, is taken quite seriously. While shares are always regarded as equity, obligations are always regarded as debt, more or

less irrespective of the true substance of the particular entitlements of the holder. Thus, preferred stock is characterised as equity under French law, even if voting rights are abandoned and the financial return or the insolvency rank is quite similar to that of a profit-dependent debt claim. On the other hand, profit-participating bonds and subordinated loans under French law are treated as debt, irrespective of their similarities with preferred stock. Contrary to this position, the United States is a typical example for a jurisdiction where a multitude of factors is used in order to identify debt and equity on a case-by-case basis. Most countries find themselves somewhere in between, starting from the extremities of fully-fledged debt and fully-fledged equity but ending up at different borderlines in between. A curious example is Switzerland where large parts of the country are either French-speaking or German-speaking. While the same statutory provisions govern civil and corporate law in these different regions of the country, academic literature in the French-speaking part tends to follow a formal approach while academic literature in the German-speaking part tends to support a “substance over form” view. This makes clear that we have to take into account cultural differences which run deeper than divergent language used by statutory law.

- A second distinction which has to be made concerns the degree of flexibility granted to enterprises and their financiers under the respective corporate and contract law. In most countries, shares and stock are defined quite narrowly under corporate law, referring to a traditional concept of “membership”, i.e. a combination of voting and control rights, participation in profits, losses and liquidation proceeds and the last rank in insolvency. The leeway accepted by domestic law to depart from this model is very different in the examined jurisdictions. Continental jurisdictions like Austria, France (until 2004), Germany and Switzerland tend to reduce the scope of available modifications, e.g. for “preferred stock”, where any reduction in voting rights has to be compensated for by a preference share in the profits. Thus, hybrid financial instruments like *jouissance* rights or profit-participating bonds have to be established on a contractual basis. Contrary to this, the United Kingdom and the United States have always shown a high degree of flexibility for the corporate statute so far. Tailor-made solutions are quite common under U.S. corporate law depending on the law of the state of incorporation. In the United Kingdom, there are gradations within the framework for corporate shares available which are simply not known to many other jurisdictions, e.g. the distinction between equity shares and ordinary shares or the concept of redeemable shares (which are also

known under French and U.S. law). Preference shares can thus be modelled to order (including fixed preference payments) under UK law as long as one basic element is obeyed: there will be no payments to shareholders which would endanger the legal capital of the company. Against this background it becomes evident that some hybrid debt instruments like profit-participating bonds or *jouissance* rights widely used on the continent simply do not find a big market under UK and US law.

- But under the auspices of the globalisation of financial markets this traditional divide between the Anglo-American and the continental world becomes blurred. To give an example: In 2004 French legislation substantially enlarged the flexibility of preferred stock, including the introduction of non-voting shares without any financial preference.

- For debt claims, however, wide-ranging contractual freedom is acknowledged everywhere as a matter of course. Thus, hybrid debt securities showing a high variability are well known in many parts of the world, in particular debt securities where fixed interest payments are replaced with profit-dependent payments. Although debt holders are no shareholders in the sense that they are allowed to vote in the shareholders' meeting, they can receive specific voting and control rights of their own, including a joint representative in company matters. Last not least, the rank of debt in the case of insolvency is more and more subject to contractual arrangements. In France, recent legislation has introduced not only subordinated loans between debt and equity but also super-subordinated loans which rank after profit-participating loans.

Taking a comprehensive view at debt and equity some general principles of corporate law enforce basically three distinctions which are virtually found everywhere: firstly, debt-holders are not allowed to vote in the shareholder's meeting; secondly, shareholders are not entitled to a distribution of profits or other financial emoluments which would touch the legal capital (in jurisdictions where the notion of legal capital still exists). Thirdly, equity always ranks at the very end when it comes to the situation of insolvency.

But these components are not authoritative for the tax labeling of the underlying financial instruments.

- First of all, it is unclear whether voting rights should be of any importance for tax law, given the fact that there exist large groups of non-voting shares under equity rules as well. Moreover, as the income tax is focused on the financial outcome of an activity, the fine-print of corporate decision-making should not be of high importance so far. Many shareholders do not exercise their voting rights anyway, experiencing the virtues of “rational apathy”.
- Secondly, the concept of legal capital concerns the conflict between any claim of shareholders to a distribution of profits and the claim of debtors to the repayment of their contribution. In some countries – like the United Kingdom – it is only applicable to public companies, in other countries it is extended to private limited companies, in the United States it is rarely applicable at all under state law. The amount of subscribed capital denotes the limit up to which dividends may be paid out of the corporate funds. In the normal situation of a profitable company, this conflict simply does not play a major role. Moreover, as corporate profits are taxed at the level of the corporation irrespective of whether they are distributed or not. Last not least it should not play a role whether the reinvestment of profits within the company is due to statutory rules on legal capital or due to the decision of the shareholders to use existing funds for further investment by the corporation.
- Thirdly, the insolvency situation should not be at the very heart of an important fork in the tax road. Firstly, also the ranking of debt claims becomes more and more refined by the invention of additional tools of mezzanine finance (including subordinated and super-subordinated debt claims) which simply plead against any bright-line dualistic approach. Moreover, it is in general totally unclear whether in a particular situation of insolvency the debt-holders, the equity holders and the mezzanine financiers will receive anything between 0 percent and 100 percent of their residual claim. It is hard to defend the relevance of an insolvency-focused distinction for the great bulk of well-being businesses where this simply does not play a role.

From this analysis it follows that the distinction between tax and equity in the tax world should take into account the particular contractual situation of a financier but not simply follow the characterisation of a financial instrument under civil and corporate law.

II. The “Partnership Situation”

As has been laid out before, the first situation where the distinction between debt and equity can come up in the context of tax law is what we would like to call the “partnership” situation. This deals with the question of whether a financier has to be regarded as a “partner” of the enterprise in the tax sense, which would lead to a joint assessment, to income measurement under the accruals method and to the treatment of losses and capital gains under the provisions relevant for business income (wherever such a distinction exists under domestic tax law).

Most jurisdictions show a very formal perspective so far: The existence of a partnership under domestic tax law requires the existence of a formal disclosed partnership under the relevant company law provisions. This includes general partnerships and limited partnerships as well as some newly established hybrids like the LLP. Contractual obligations, on the other hand, are regularly not characterised as partnerships, even if the contract partner is entitled to a share in the business profits, suffers losses and may even hold some governance rights in the business. Thus, in the United Kingdom, in the United States, in France and in Switzerland we did not find any indication that a “partnership” might exist for tax purposes on a merely contractual, internal basis. The situation is quite different in Austria and Germany where “silent partnerships” are commonly used. Nevertheless, the typical “silent partnership” where the financier participates in the annual profits (and – depending on the contractual agreement – in the losses) and will be paid back his contribution after the partnership is cancelled, is characterised in these countries as a regular debt-claim not unlike a profit-participating loan. But the so-called “atypical silent partnership” where the financier also participates in the latent gains of the capital assets of the enterprise, including self-created intangibles and a self-created good will (which are not shown in the balance sheet), is truly regarded as a fully-fledged partnership under tax law, transforming the financier into a full partner in the business for tax purposes. Thus, formal distinctions between an outspoken partnership agreement and an analogous contractual arrangement become irrelevant.

Taking a closer look, it seems strange that only Austria and Germany have introduced this substantial extension to the notion of a partnership. But there are reasons for this treatment: As Austrian and German tax law leave capital gains in the private sector untaxed while capital gains in the business sector are subject to tax, the inclusion of “atypical silent partnerships” was meant to provide

coverage for taxpayers who invest in a business on a contractual basis which emulates the financial position of a full partner under company law.

III. The “Shareholder Situation”

The second situation which is addressed by the debt-equity divide under domestic tax law concerns the corporate income tax. While the return on equity – the corporate profit – is taxed twice, both at the level of the company and at the level of the shareholder, any return on debt is regularly deducted at the corporate level as business expenditure.

From the point of view of tax law it seems irrelevant in the first place whether hybrid financial instruments are treated as debt or equity in the domestic situation. After all, the return on investment will be taxed at least once. To the contrary, one could easily reach the conclusion that debt treatment should be the governing concept while equity treatment involving a double layer of tax seems to represent an irregularity within the framework of mainstream income taxation. Insofar, equity treatment cannot claim to be “more” legitimate or compliant with basic structures of tax law. Of course, it has to be ascertained that business expenditure at the corporate level is accompanied by full taxation at the level of the debt holder. In the United States, provisions safeguarding the so-called “consistency rule” have been enacted in 1992 to ensure one-time taxation of out-flowing payments as interest.

Nevertheless, the corporate income tax does exist and has to be taken as the starting point of the analysis. It has to be accepted that by an act of legislation the ordinary shareholder does suffer double taxation (including the benefits of a reduced corporate tax rate and other means of “integration” for individual income tax and corporate income tax). Insofar, the main topic is arbitrage: to what extent shall the taxpayer be entitled to emulate a “shareholder” position on a contractual basis without coming under the provisions of the corporate income tax including double-layer taxation. From the other side of the continuum one has to ask to what extent a shareholder shall be entitled to modify his regular corporate entitlements, e.g. abandon voting rights or gain a fixed preference, without falling under the rules of debt treatment. To be frank, it seems to be absolutely defensible to grant

the taxpayer an election so far. As long as – in many countries – the partners of a partnership can choose to be treated like a corporation and as long as LLCs and LLPs or S-Corporations can opt for transparent taxation it makes sense to simply leave it to the financiers to opt for debt treatment or equity treatment. At least from the point of view of domestic tax law there is no logically superior solution.

Nevertheless, the examined jurisdictions do not simply leave it to the financiers whether to be taxed as equity holders or debt holders. But the focal points of the respective analysis differ widely. The United States show the highest degree of a “substance over form” analysis: up to 38 factors have been identified which contribute to the overall picture, starting with the simple “name” of the financial instrument, including components like the maturity date, the dependence on corporate earnings, the risk of repayment or the subordination of the contributed capital. Insofar, the “legal nature” of the financial instrument, in particular its basis in corporate or contract law, is not of high relevance.

Most other countries, however, start from the assumption that an entitlement under corporate law is deemed to constitute equity. This does not only include equity shares and ordinary shares but also preferred stock. Under the tax laws of Austria, France, Germany, Switzerland and the United Kingdom, preference shares are treated as equity under domestic tax law, even if voting rights have been abandoned and a fixed preference is paid to the shareholder. Insofar, the formal basis of the instrument in the company statute plays an important role. Moreover, redeemable shares as they exist in the United Kingdom and have been introduced in France are treated as equity in this sense. The very idea of the corporation tax as a particular tax on the corporation’s profits seems to support the inclusion of all shareholders into the corporate tax regime irrespective of their particular entitlements. In the United Kingdom, only rare cases of “shares accounted for as liabilities” may fall under debt treatment according to recently enacted anti-avoidance provisions.

Things are much more complicated and diverse when it comes to the inclusion of hybrid contractual claims into equity treatment. Insofar, several traits and distinctions come into play. In this context, voting and control rights play a minor role while the financial entitlements of the holder of a financial instrument are of much more relevance. Thus, in the U.S., a fixed maturity date can be decisive

for characterisation as debt while in the United Kingdom even “perpetual bonds” qualify as debt under domestic tax law as long as they provide for a fixed amount of interest.

One possible starting point is the basic distinction between interest as a “payment by time for the use of money” and a share in the business profits on a contractual basis. Basically, all countries characterise obligations carrying fixed interest payments as debt. This also means that the insolvency situation, in particular subordination of loans, does not play a major role so far. As long as a consideration for the capital is paid as fixed interest, subordination does not play a role (even if it is compensated by an interest rate above the standard market rate). As far as we found out, only in the U.S., particular high-yield bonds can qualify for equity treatment if the interest rate exceeds the market rate by 5 % and is accompanied by a large discount on the issue.

On the other hand, there is no uniform characterisation of profit-participating obligations and related financial instruments. The broadest view is taken by UK tax law where a narrow notion of interest prevails while any linkage of the investor’s return to the respective company’s profit leads to the non-deductibility of payments, thus creating equal treatment with regular corporate profits on equity. Only profit-dependent payments to domestic corporations are treated as deductible interest to a certain extent. Any interest payments which are meant to qualify for deductibility may be limited by the annual amount of disposable profits, but they should be cumulated and be paid at the latest in the course of liquidation if debt treatment under UK tax law shall apply.

Austrian, German and Swiss laws, on the other hand, do not stipulate that a contractual share of the profit of a company leads to a full inclusion of the respective payments into the company’s profit for the purpose of corporate income taxation. Profit-participating bonds are treated as debt, leading to full deductibility of profit-dependent payments. Even the distribution of a profit to a silent partner, who participates in the corporate losses as well, qualifies as business expenditure in Austria and Germany.

Only the position of a financier who is entitled to both profit-dependent payments and a share in the liquidation proceeds of the company (including latent gains from self-created intangibles and a

good will) is deemed to be sufficiently similar to an ordinary share and will be subject to equity treatment. This is laid out in German and Austrian corporate tax law by specific rules on “jouissance rights” issued by corporations. Switzerland knows a similar treatment for “participation certificates” which are formed under corporate law and show a great degree of similarity to preferred stock. In France, different sorts of profit-participating loans exist (the “titre participatif” and the “prêt participatif”) but they all fall under the rules on debt treatment as well as subordinated loans, although their economic substance is quite similar to preferred stock.

Against this background, there seems to be no consensus where to draw the dividing line between debt and equity. The main point of disagreement concerns the simple contractual agreement to contribute capital against a share in the company’s profit without any further financial entitlements or control rights. It may well be that the relevant benchmark, i.e. the position of a shareholder, looks different in the examined countries. In the United Kingdom where the position of a shareholder is largely the object of modification by the company statute it makes sense to deny interest treatment to all profit-dependent payments. In the countries of continental Europe where the position of a shareholder is much less flexible and regularly does not suffer abandonment of voting rights (without any compensation) or a waiver to participate in liquidation proceeds, the hypothesized similarity between a contractual and a corporate position requires more than simply a participation in the corporate profit. Insofar it makes sense to make the qualification of contractual positions as “equity” dependent on a far-reaching similarity to common stock.

IV. The “Source Situation”

In the international situation, the distinction between debt and equity plays a major role when it comes to the allocation of taxing rights between countries. The basic situation is the following: The financier is a resident of Country A, the recipient of the capital is a resident of Country B. Will the return on investment be taxed in Country A, in Country B or in both of the involved jurisdictions?

Insofar, the analysis can build on the foregoing remarks to the “partnership situation” and the “shareholder situation”. Whenever the financier is characterised as a “partner” in the business lo-

cated in Country B, this business will be regarded as his permanent establishment, thus allocating the right to tax to Country B. A similar outcome is created by the “shareholder situation”: Whenever the financier is characterised as an equity-holder in a resident company under the domestic tax law of Country B, the return on his investment will be taxed as a part of the corporate profit, thus securing the taxing right of Country B. In a second step, the distribution to the shareholder might be subject to a withholding tax on dividends dependent on domestic tax provisions and any modifications provided by double taxation conventions, e.g. a reduced withholding tax rate or a waiver of withholding tax in the context of substantial participations.

Thus, the main question is if and how any payments to the financier which are simply treated as business expenditure under domestic tax law, shall be subject to an additional layer of source taxation when they are paid to foreign resident taxpayers. Insofar, a withholding tax on out-flowing interest payments springs to mind. In order to achieve full neutrality, one could easily conceive a withholding tax on interest payments which emulates the tax burden created for dividends by the underlying corporate income tax and any additional withholding tax on dividends. In reality, however, withholding taxation on interest payments is rather small or even completely waived. Countries like France, Germany and the United States have unilaterally abolished withholding taxation for some or all kinds of foreign portfolio interest. Even the United Kingdom has done so for particular bonds. This is due to international tax competition: governments try to reduce the tax burden on inflowing debt capital.

Against this background, the major question for most unilateral and bilateral rules on interest and on dividend taxation concerns the dividing line between debt and equity, in particular the necessity to extend the notion of dividends to payments otherwise characterised as business expenditure under domestic tax law.

This is of no great concern for a country which employs a pretty narrow concept of interest under domestic tax law like the United Kingdom where profit-dependent payments are not deductible in the first place. Here only atypical interest-bearing instruments like “perpetual bonds” which lack a fixed maturity date may be subject to re-characterisation. The situation is quite different in countries

where profit-participating loans and similar financial instruments regularly qualify for debt treatment under domestic tax law. There is a clear tendency in the examined countries to levy a withholding tax on any profit-dependent payments to foreign residents. In the United States, the unilateral abolition of the withholding tax on foreign portfolio interest does not apply to “contingent interest” the amount (not the timing) of which is dependent on the financial success of the debtor (profit, sales or receipts). This right to levy such a withholding tax is maintained in Art.11 par.2 US Model Treaty. In Germany, payments to silent partners, which are deductible as business expenditure under domestic tax law, are subject to limited tax liability under international tax rules. The same holds true under Austrian tax law. A difference between Austrian and German tax law concerns profit-participating loans (which are hard to distinguish from silent partnerships under the concept of a “common purpose”); these are generally qualified as debt under Austrian international tax rules and not covered by limited tax liability but they are subject to a withholding tax under German tax law. Under German tax jurisprudence, even a consideration for a loan which is linked to the turnover of the debtor’s business qualifies for this treatment. This can lead to a strange outcome: While the DTC Austria/Germany entitles each country to levy a withholding tax on payments under profit-participating loans, only in Germany domestic tax law provides a legal basis for such taxation.

It is quite evident that in bilateral tax treaties countries take into account financial instruments which are more common in one of the involved countries than in the other and agree on policy directions taken by one of the involved countries. Thus, a country like France which largely follows the national rules on the debt-equity divide also for international tax purposes has agreed in its treaty with the United States on a withholding tax on profit-dependent payments and has agreed in its treaty with Germany on a withholding tax on profit distributions under silent partnership agreements, profit-participating loans and other profit-dependent instruments. Also Switzerland has agreed in its DTC with Germany on a similar treatment.

This overview leads to the question why there is a tendency in international tax law (both at the unilateral and at the bilateral level) to levy a withholding tax on profit-dependent payments while fixed interest payments have become more and more free of source taxation. The answer can be

found in the dynamics for tax competition. While we witness a far-reaching waiver of interest taxation at source, the taxation of business profits at source (both in the context of permanent establishments and in the context of the corporate income tax on local subsidiaries of foreign shareholders) has been reduced but by no means abolished. Thus, international tax policy shows a tendency to uphold taxation of business profits in general. This may be due to the fact that the global market interest rate for debt cannot be influenced by individual market participants and (small) countries, while the actual profit of a firm may be traced back to circumstances which are proprietary to the country of source. Insofar, the pressure of tax competition might work differently for profit-dependent and fixed-interest financial instruments.