

Wolfgang Schön, Andreas Bakrozis, Johannes Becker,
Tobias Beuchert, Martin Boer, Nadja Dwenger,
Andreas Gerten, Maximilian Haag, Sabine
Heidenbauer, Carsten Hohmann, Alexander Jehlin,
Karin E.M. Kopp, Daniel Kornack, Nadia
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Erik Röder, Astrid Roesener

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Max Planck Institute for Tax Law and Public Finance
Working Paper 2014 - 09

June 2014



Max Planck Institute for
Tax Law and Public Finance

Department of Business and Tax Law
Department of Public Economics

<http://www.tax.mpg.de>

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Max Planck Institute for Tax Law and Public Finance
Marstallplatz 1
D-80539 Munich
Tel: +49 89 24246 – 0
Fax: +49 89 24246 – 501
E-mail: ssrn@tax.mpg.de
<http://www.tax.mpg.de>

**Reprinted from British Tax
Review
Issue 2, 2014**

Sweet & Maxwell
100 Avenue Road
Swiss Cottage
London
NW3 3PF
(Law Publishers)

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Debt and Equity in Domestic and International Tax Law—A Comparative Policy Analysis

Wolfgang Schön,* Andreas Bakrozis, Johannes Becker, Tobias Beuchert, Martin Boer, Nadja Dwenger, Andreas Gerten, Maximilian Haag, Sabine Heidenbauer, Carsten Hohmann, Alexander Jehlin, Karin E.M. Kopp, Daniel Kornack, Nadia Lagdali, Christian Marquart, Lukas Müller, Marta Oliveros Castelon, Christine Osterloh-Konrad, Natalia Paxinou, Carlo Pohlhausen, Philipp Redeker, Erik Röder, Astrid Roesener

The demarcation between debt and equity is a long-standing core constituent of company and taxation law the world over. However, its sustainability for national and international taxation regimes is increasingly the subject of doubt. Domestic and international proposals for reform are directed towards either rendering the classification of financial instruments as equity or debt legally superfluous or robbing it of economic meaning. With the comprehensive comparative legal analysis in this article and the economic reasoning behind the distinction as background, a new structure for the relationship between debt and equity will be advanced. In doing so, the corporate and contract law background (including the flexibility) of each type of capital will be illuminated and the tax purpose of the relevant standards will be reviewed. It will become apparent that in income taxation, corporate taxation and international taxation law, a variety of legislative policy concerns influence the distinction between debt and equity and hence require differing demarcations. The resulting framework can also contribute to the current debate on “hybrid mismatches” with financial instruments.

Introduction

One of the fundamental landmarks in the corporate finance sector is the dichotomy between debt and equity. This division underpins not only the economic analysis of the optimal financial structure¹; it also arises in several areas of law and gives rise to diverse legal consequences.

* Director, Max Planck Institute, Munich; all co-authors of this article are or were researchers at the Max Planck Institute for Tax Law and Public Finance in Munich. The article summarises the findings of a research project conducted at the institute in 2008–2013; earlier findings have been presented at the Oxford University Centre for Business Taxation in 2009 (W. Schoen et al., “Debt and Equity: What’s the Difference?” available at: <http://www.ssrn.com/en/> [Accessed April 7, 2014]) and at the University of Sydney and Cambridge University in 2011 (W. Schön, “The Distinct Equity of the Debt-Equity Distinction” (2012) 66 *Bulletin of International Taxation* 490–502); an enlarged version of this article accompanied by country reports and topic reports in the German language can be found in: W. Schön (ed.), *Eigenkapital und Fremdkapital: Steuerrecht—Gesellschaftsrecht—Rechtsvergleich—Rechtspolitik* (Berlin/Heidelberg: Springer-Verlag, 2013), 1 and following; our gratitude for the translation goes to Anna Wilson (Melbourne).

¹ J. Tirole, *The Theory of Corporate Finance* (Princeton: Princeton University Press, 2006), 76 and following; R.A. Brealey, S.C. Myers and F. Allen, *Principles of Corporate Finance*, 9th edn (New York: McGraw-Hill, 2008), 472 and following.

The distinction has its origin in the law of partnerships and corporations.² In this context, equity includes the funds provided by partners or shareholders that give the operation its economic foundation, that provide the basis for the calculation of profit shares and the pay-out entitlements of a retiring partner/shareholder, and that are ultimately available to creditors of the undertaking as a capital sum.³ From these beginnings, the conceptual pair debt/equity has found its way into the ordinary domestic and international regulatory framework for business financial reporting—regardless of whether the purpose behind this is the calculation of distributable profits or first and foremost the provision of information to partners/shareholders, creditors, investors and third parties.⁴ In turn, multilateral agreements and rules for the domestic implementation of banking regulations in the credit institutions sector refer to these parameters.⁵ Ultimately—and this is the focal point of this article—the contrast between debt and equity constitutes the starting and reference point for a wealth of issues in national and international taxation law.

The current practice for the differentiation of debt and equity is the subject of vigorous discussion in tax circles. The omnipresent criticism focuses not only on the confusing variety and complexity of domestic tax systems in practice but also looks deeper and doubts the fundamental legitimacy of this dichotomy as such.⁶ Weighty, internationally discussed proposals for reform aim to iron out the existing tax advantages and disadvantages of the different forms of finance.⁷ Some states have already taken genuine legislative steps in this direction.⁸ Ultimately, the incongruity in the definitions of debt and equity in domestic law leads to monetary payments in cross-border transactions being subject to either multiple- or non-taxation in the relevant states, depending on the chosen structure, and therefore gives rise to a number of opportunities for taxation arbitrage with hybrid financial instruments.⁹ Against this background, the International Fiscal Association discussed the *debt-equity-conundrum* as one of its main subjects at the 2012 Annual Congress in Boston.¹⁰

² K. Schmidt, *Gesellschaftsrecht*, 4th edn (Cologne: Heymanns, 2002), 515 and following; R. Kraakman et al., *The Anatomy of Corporate Law*, 2nd edn (Oxford: OUP, 2009), 115 and following.

³ In detail: T. Baums, “Eigenkapital: Begriff, Aufgaben, Sicherung” (2011) 175 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 160.

⁴ Regarding the varying notions of equity according to the German Commercial Code and IAS/IFRS see: J. Wüstemann and J. Bischof, “Eigenkapital im nationalen und internationalen Bilanzrecht: Eine ökonomische Analyse” (2011) 175 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 210; D. Kleindiek, “Eigenkapital im nationalen und internationalen Bilanzrecht: Kapitalabgrenzung nach IFRS und HGB” (2011) 175 *Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht* 247.

⁵ M. Schaber, D. Amann and A. Maucher, “Hybridkapital im KWG und in der internationalen Rechnungslegung” [2011] *Wirtschaftsprüfung* 581.

⁶ A.J. Auerbach, M.P. Devereux and H. Simpson, “Taxing Corporate Income” in Institute for Fiscal Studies, *Dimensions of Tax Design: The Mirrlees Review (The Mirrlees Review)* (Oxford: OUP, 2011), 837, 857 and following; *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF-Staff Discussion Note (2011).

⁷ On the one hand the concept of the *allowance for corporate equity* (ACE) of tax-free sheltered interest payments on invested equity and on the other hand the concept of the *comprehensive business income tax* (CBIT) with the prohibition for the deduction of interest payments on debt.

⁸ See e.g. the introduction of an ACE in Belgium and Brazil.

⁹ OECD, *Addressing Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), 40 and following; OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD Publishing, 2013), 15 and following (“Action 2: Neutralise the effects of hybrid mismatch arrangements”).

¹⁰ P.H. Blessing, “The Debt-Equity Conundrum—A Prequel” (2012) 66 *Bulletin of International Taxation* 198; P. Brown, “The Debt-Equity Conundrum, General Report” (2012) 97b *Cahiers de droit fiscal international* 17.

The following analysis concentrates, therefore, on the provisions in corporate law and the law of obligations regarding the distinction between equity and debt (with its connections to insolvency law) as well as the important features of the various forms of finance for tax law purposes. The reason for this approach is that corporate law and the law of obligations (including insolvency law) are determinative of the relevant property rights and procedural rights analysis, which in turn leads to certain consequences under tax law. The critical question is whether and which private law distinctions can justify different tax law consequences from a tax law perspective. This is *prima facie* problematic because of the binary classification between debt and equity which exists in many instances in tax law, in stark contrast to the private law perspective which considers there to be a continuum of financial instruments containing various—almost random—collections of property and procedural rights for investors, without any distinguishing feature clearly standing out.¹¹

From this perspective, financial reporting plays an ancillary role only, because it ultimately draws distinctions on the basis of the same characteristics of financial instruments that are used by corporate law and the law of obligations, but for the completely different purpose of preparing corporate reports or setting the upper limit for profit distributions. In fact, in some legal systems the distinction between debt and equity for accounting purposes is also made applicable to tax law on the basis of the principle of “linkage” (*Maßgeblichkeitsprinzip*)—the principle that the same standards should be applicable to both tax and commercial accounting—as can be seen in Germany with the classification of instruments under the German Commercial Code¹² or in Britain with the classification under the IAS/IFRS.¹³ However, it must be considered whether these commercial classifications can be used for tax law purposes not only formally but rather also substantively.

Accordingly, a legal comparison of the corporate law and law of obligations’ origins of financial instruments will be undertaken in the first section of this article. For this purpose, the national reports developed at the Max Planck Institute for Tax Law and Public Finance for Brazil, Germany, France, Greece, Holland, Austria, Switzerland, the UK and the US will be analysed.¹⁴ In the—core—second part of the article, the key issues from a tax policy perspective regarding the demarcation between debt and equity will be laid out and, on the one hand with regard to the tax principles on which they are based and on the other hand with reference to the corporate law requirements mentioned above, these issues will be developed. In the third part, international tax issues are addressed, for example the interpretation of the OECD Model Convention, international withholding tax practice as well as the restrictions on the deductibility of interest and special provisions regarding shareholder/partner debt finance.

¹¹ Regarding the problem of the “tipping point” in the tax treatment of continua see: W. Schön, “International Tax Coordination for a Second-Best World, Part 1” (2009) 1 *World Tax Journal* 67.

¹² Compare e.g. BFH (*Bundesfinanzhof*—Federal Fiscal Court) BStBl (*Bundessteuerblatt*—Federal Tax Gazette) II 2008, 809; BFH/NV (*Bundesfinanzhof/Nicht Veröffentlicht*—Federal Fiscal Court/Unreported decision) 2006, 616.

¹³ Compare for instance CTA 2009 s.307(2) (loan relationships); CTA 2009 s.415 (loan relationships with embedded derivatives); CTA 2009 s.521C(1)(a) (shares accounted for as liabilities).

¹⁴ W. Schön (ed.), *Fremdkapital und Eigenkapital: Steuerrecht—Gesellschaftsrecht—Rechtsvergleich—Rechtspolitik* (Berlin/Heidelberg: Springer Verlag, 2013); see also Brown, above fn.10, 35 and following.

Equity and debt in corporate law, partnership law and contract law

Association versus contract

The guiding principle for the classification of a financial instrument as equity in all of the examined legal systems is the legally binding association of persons under corporate or partnership law for a common (commercial) purpose. All financial contributions made by the (core) partners/shareholders on the basis of the partnership agreement/company statute are bundled together under the concept of equity.¹⁵ The following principles apply to the legal status of these partners/shareholders:

1. The partners/shareholders have joint control of the assets and the operation of the enterprise. These control rights can be delegated to external managers by operation of law or in accordance with the constitution/partnership agreement. The individual partners/shareholders have certain participation rights due to their involvement, for example, rights of management, voting and control, which can differ according to the type of enterprise and the character of their involvement.
2. The partners/shareholders share in the profits and losses of the business; they also have (proportionate) rights to the proceeds of liquidation on a winding up of the enterprise. They are jointly liable to the creditors of the enterprise—to the extent of their capital contribution or to an unlimited extent.
3. In the event of insolvency, the creditors all rank in priority to the holders of equity. The rank amongst the creditors can, however, be further differentiated, as can the rank amongst the holders of equity.
4. For companies, a distribution to shareholders at the expense of creditors is in principle prohibited; however the limitations on the reimbursement of capital contributions vary according to the legal form. In any case, a system whereby the share capital is fixed does not exist in all countries nor for all legal forms. The over-indebtedness of the enterprise (determined in accordance with a solvency or balance sheet test) often acts as the final limit for pay-outs to partners/shareholders.

It follows from this that it is up to the parties as a first step to privately determine if and to what extent equity holdings will be established. Only those who will be parties to the partnership agreement or company statute will be deliberately admitted into the circle of equity investors from the outset. This consequence can be clearly seen under British law: he who is listed as a *member* in the documents establishing the entity will thereafter be plainly seen as an equity investor.¹⁶

The creditor is, in contrast, connected to the enterprise (company/partnership) via a loan agreement, which does not mandate the pursuit of a common purpose but rather the exchange of performance for consideration. The obligations under a fixed interest loan provide a good example. These include the following:

¹⁵ Schmidt, above fn.2, 515.

¹⁶ Companies Act 2006 ss.112, 16(5). See also P. Harris, *Corporate Tax Law—Structure, Policy and Practice* (Cambridge: CUP, 2013), 188 and following.

1. The creditor has no joint proprietary or corporate law rights to the assets of the enterprise. The starting point is that he has no rights of management, voting or control, even if it may be possible for these to be granted on a contractual basis.
2. The creditor possesses a fixed right to the repayment of the given capital sum as well as to payment of a fixed amount of interest. This right is often provided with additional security.
3. In the event of insolvency, his claim will have priority over those of the equity investors.
4. For companies, payments to creditors are not subject to capital maintenance limits or other prohibitions on distributions (balance sheet or solvency tests).

In this respect the general principles for debt and equity are uniformly formulated in all legal systems. From a legal comparison perspective the remaining question is whether it is possible to deviate so far from this model of members versus creditors that a membership right can be subsumed by the concept of debt or that a contractual entitlement can be classified as equity. In this respect—and this is indicated by the national reports—the examined legal systems have developed very differently.

Deviations from the equity model permitted by corporate/partnership law

This will initially be considered using the example of a partner/shareholder whose legal position differs from the model equity investor described above. The key question is whether and to what extent the property and procedural rights can be modified within the framework of a corporate/partnership law membership.

Proprietary participation rights

A central question is whether a share in a partnership or company can be issued without proprietary participation rights. Whereas such a contractual arrangement is unknown in corporate law, in the law of partnerships such an “undisclosed partnership” appears unproblematic. Even the Roman law *societas* was drawn up simply as an internal contractual relationship of the *socii*.¹⁷

Today the undisclosed partnership lives on in many legal systems, most notably in the form of a “silent partnership” of a commercial business. The hybrid character of a silent partnership can be seen in the fact that it is not based on any common business assets, but the trader’s enterprise is run partially for the account of the silent partner. In other words: the general partner as well as the silent partner are the relevant “providers of funds” for their mutual partnership. It is therefore not surprising that the silent partnership—depending on the legal system and contractual content—is classified as a partnership or even as a body corporate¹⁸ for tax purposes. But once again the legal position appears to be different in England. Here, (in contrast to Scotland) the distinction between joint ownership and a contractual relationship appears to have no meaning

¹⁷ Flume, *Allgemeiner Teil des Bürgerlichen Rechts, Die Personengesellschaft* (Berlin et al.: Springer, 1977), Vol.1/2, §1 III, 4 and following.

¹⁸ Decree No.3000/99 (DOU = Diário Oficial da União, March 29, 1999; DOU June 17, 1999) Art.148; Law No.2308/86 (DOU December 22, 1986) Art.3.

at all because a partnership is not considered to be an independent legal entity.¹⁹ The *dormant partner* is distinguished from the regular *partner* not by his lack of joint rights over the assets of the enterprise, but rather much more through his passivity or lack of relationships with third parties.²⁰

A silent partnership can be arranged in a number of ways. This is true of the share of the silent partner in the assets of the partnership and also with regard to his participation rights: according to German law it can be agreed that the silent partner will only share in profits and not in losses, or that, in addition to his participation in current profits, he will also participate in any (potential) latent gains and that he therefore holds a share in the hidden reserves of the enterprise.²¹ The silent partner can also be provided with comprehensive participation rights.²² In France, however, if the silent partner does not participate in losses, the agreement is automatically classified as a participating loan.²³ If the capital investor participates in losses and has management, voting and control rights, then, by way of contrast, the definition of a partnership is automatically met.²⁴

Ultimately, it is possible to use contract law to give the silent partner a contractual position which is very similar to the financial and participation rights that a partner in a partnership based on proprietary rights would have. In this sense the silent partner's capital contribution can also be classified as equity, in any case as equity at the level of the silent partnership, not necessarily as equity in a corporation where a silent participation in the corporation's enterprise exists.

Revocability of membership

The members of a partnership or corporation are in principle committed to the partnership or corporation until its liquidation. This begs the question for individual legal systems as to whether the membership of certain members can be limited in time or whether the other members (or governing bodies of the enterprise) can be granted the right to expel them.

While partnership law typically gives the partners comprehensive autonomy as to whether, for what reason and for how much compensation membership can be revoked,²⁵ the legal situation for stock rights in the examined jurisdictions is very diverse. In Germany as well as Austria²⁶ and Switzerland,²⁷ a shareholder's membership is in principle permanent. Aside from the special situation of a revocation for good cause, an equity investor remains a member of the corporation until its liquidation.

In contrast, in recent years the concept of *redeemable shares* has—beginning with the UK and the US—spread internationally, that is, shares that can be bought back by the corporation

¹⁹ R. Banks, *Lindley & Banks on partnership*, 19th edn (London: Sweet & Maxwell, 2010), 36.

²⁰ Banks, above fn.19, 93.

²¹ K. Schmidt in K. Schmidt (ed.), *Münchener Kommentar zum Handelsgesetzbuch*, 3rd edn (Munich: Beck, 2012), §230 note 79.

²² K. Hopt in A. Baumbach, K. Hopt (eds), *Handelsgesetzbuch*, 36th edn (Munich: Beck, 2014), §233 note 12.

²³ P. Merle, *Droit commercial—sociétés commerciales*, 17th edn (Paris: Dalloz, 2014), para.714.

²⁴ Merle, above fn.23, para.709.

²⁵ For German law: B. Grunewald, *Der Ausschluss aus Gesellschaft und Verein* (Cologne: Heymanns, 1988); legal comparison: H. Fleischer in Bachmann et al. (eds), *Rechtsregeln für die geschlossene Kapitalgesellschaft* (Berlin: de Gruyter, 2012), §3 C III.

²⁶ H. Krejci and R. van Husen, "Über Genussrechte, Gesellschafterähnlichkeit, stille Gesellschaften und partiarische Darlehen" [2000] *Zeitschrift für Gesellschafts- und Unternehmensrecht* 54, 56.

²⁷ Swiss Code of Obligations Art.680 s.2.

(for consideration).²⁸ This buy-back right can in some cases be exercised at will by the governing bodies of the enterprise or a fixed schedule can be prescribed (as is the case for the US American *mandatorily redeemable preferred stock*²⁹). Under British law, *ordinary shares* as well as *preference shares* can be issued with this buy-back right.³⁰ In the US the *redemption* is usually determined by the *board*. The same holds true in the UK where the general meeting can additionally grant authority to the management to determine the terms, conditions and manner of redemption.³¹ The member can also be given the right to offer his shares to the corporation for consideration.

Following this model, in France *actions de préférence* can be issued with a buy-back right since the 2004 reforms (it is commonly assumed that this can also include an entitlement on the part of the shareholder to offer his shares to the corporation).³² This is also true of Greece since 2007.³³ In both France and Greece the general meeting is in principle responsible for the decision; but the board can be given authority to execute a buy-back. In this respect care must be exercised because—on the basis of capital protection under corporate law—such a buy-back may not be undertaken with protected capital.³⁴ This also applies in the UK but with the proviso that the Companies Act 2006 (against the backdrop of the strict rules of the 2nd European Directive for Companies limited by shares³⁵) only consistently enforces this principle for *public limited companies* and has accepted a relaxation of the rules for *private limited companies*.³⁶

In contrast, the German legislature (still) upholds the principle of the irrevocability of the membership of a company. The recent proposal to allow redeemable shares³⁷ has not been moved forward by the German Government³⁸ nor by the German Federal Council's³⁹ paper regarding the 2012 Bill to amend Germany's Stock Corporation Act.

Participation rights

Partnerships can, to a large extent, determine the legal position of the partners with regard to participation rights. General partners and limited partners are already distinguished by operation

²⁸ For the US compare Revised Model Business Corporation Act s.6.01(c)(2); Delaware General Corporation Law s.151(b).

²⁹ L.A. Nikolai, J.D. Bazley and J.P. Jones, *Intermediate Accounting*, 11th edn (Mason: South-Western, 2010), 690; S. Bragg, *Wiley GAAP 2011* (Hoboken, New Jersey: John Wiley & Sons, 2010), 1042.

³⁰ Companies Act 2006 s.684; E. Ferran, *Principles of Corporate Finance Law* (Oxford: OUP, 2008), 156.

³¹ Companies Act 2006 s.685.

³² A. Couret and H. Le Nabasque, *Droit financier* (Paris: Dalloz, 2012), para.420.

³³ N. 2190/1920 Art.17b(1).

³⁴ N. 2190/1920 Art.17b(3c).

³⁵ Directive 2012/30/EU of the European Parliament and of the Council of 25 October 2012 on coordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent Text with EEA relevance.

³⁶ Companies Act 2006 ss.687, 709 and following.

³⁷ Handelsrechtsausschuss des Deutschen Anwaltvereins (Commercial Law Committee of the German Law Association), "Stellungnahme zum Referentenentwurf eines Gesetzes zur Änderung des Aktiengesetzes (Aktienrechtsnovelle 2011)" [2011] *Neue Zeitschrift für Gesellschaftsrecht* 217, 220.

³⁸ BR-Drs.(Bundesrat Drucksachen) 852/11.

³⁹ BR-Drs.852/11(B).

of law in that limited partners have no right to participate in the day to day business management.⁴⁰ But limited partners can also waive the right to approve fundamental business matters in the partnership agreement. At the end of the day, even the right to information can be privately determined, although in Germany since the introduction of the statutory right to information in §51a GmbHG (Gesetz betreffend die Gesellschaften mit beschränkter Haftung—Limited Liability Companies Act) for shareholders of private limited companies, demands have been made that limited partners should also have an irrevocable right to a minimum level of information.⁴¹ There are similar proposals for an irrevocable right to key information for silent partnerships.⁴²

For companies, participation rights can be cut back or extended in a wide variety of ways and to a greater or lesser extent. On closer examination, the following conclusions can be drawn:

The voting rights of the shareholders can be removed in all of the examined legal systems. First and foremost this affects decisions about the day-to-day operations, for example the election of board members or decisions about the distribution of profits (in so far as the law authorises the shareholders to deal with these matters). But even the holders of non-voting shares often have rights to participate where fundamental changes are concerned. Ultimately, basic shareholder protections cannot be revoked including participation rights, rights to information and rights to sue.

Fundamental differences appear between different jurisdictions, however, with regard to the question of how widely the circle of non-voting shares can be drawn and if the waiver of voting rights has to be balanced by preferred treatment in dividend payments. The most liberal regimes are to be found in the US and the UK. In the US, to give effect to freedom of association, the only requirement is that there must be one class of shares (or one single share⁴³), with voting rights, whereas all other classes of shares can be issued without voting rights, regardless of whether this is balanced by financial preferences.⁴⁴ In the UK not only *preference shares*, but also *ordinary shares* can be issued without voting rights so long as some non-redeemable *ordinary shares* with voting rights remain in circulation.⁴⁵ Financial compensation is permitted, but not required. Swiss law achieves a similar result via its own legal concept of the participation share (*Partizipationscheine*), which is simply tailored like a non-voting share⁴⁶ (whereas Swiss preference shares do not limit the voting rights, they simply provide for a preferred financial position⁴⁷).

⁴⁰ For the UK cf. Limited Partnerships Act 1907 s.6(1).

⁴¹ Grunewald in Schmidt, above fn.21, §166 note 11 and following.

⁴² Schmidt in Schmidt, above fn.21, §233 note 25.

⁴³ Delaware General Corporation Law s.151(b)s.1.

⁴⁴ J.D. Cox and T.L. Hazen, *The Law of Corporations*, 3rd edn (St Paul: West, 2010), Vol.3, §18:4; T.L. Hazen and J.W. Markham, *Corporations and other business enterprises*, 2nd edn (St Paul: Thomson/West, 2007), 122 and following.

⁴⁵ Companies Act 2006 s.684(4). Compare D. French, S. Mayson and C. Ryan, *Company Law*, 30th edn (Oxford: OUP, 2013), 170 and following.

⁴⁶ Swiss Code of Obligations Art.656a and following.

⁴⁷ A. Meier-Hayoz and P. Forstmoser, *Schweizerisches Gesellschaftsrecht—mit Einbezug des künftigen Rechnungslegungsrechts und der Aktienrechtsreform*, 11th edn (Bern: Stämpfli, 2012), §16 note 270.

German⁴⁸ and Brazilian⁴⁹ law limit the number of non-voting shares to 50 for every 100 issued. The same is true in France for unlisted companies; for listed companies the number of non-voting shares may be only 25 for every 100 issued.⁵⁰ Austrian law provides for a limit of a third of the total share capital.⁵¹ Further, German law requires⁵²—as does Brazilian,⁵³ Greek⁵⁴ and Austrian⁵⁵ law—preference dividends as compensation for the waiver of voting rights (which can, however, be minimal). If these are not paid, the voting rights are rekindled. In contrast, in France since 2004, the “preference” associated with the *actions de préférence* can simply be the removal of the voting rights, and the granting of financial compensation is completely optional.⁵⁶ However, the shareholders’ rights to information cannot be removed⁵⁷ and it is not possible for the corporation’s governing bodies to avoid their mandatory statutory responsibilities.⁵⁸

Modification of financial entitlements

There are many and various ways in which the financial entitlements of shareholders can be modified by the participants. These affect in particular the configuration of ongoing monetary payments (profit share or interest) as well as the shareholders’ entitlement to share in the proceeds of liquidation. All legal systems share the feature that equity is fundamentally subordinate in the event of insolvency. Additional common features are prohibitions on distributions under corporate law or insolvency law that either protect the subscribed capital or—subject to a balance sheet or solvency test—are designed to guarantee compliance with liabilities to third parties.

The payment of dividends from the company’s net profits constitutes the typical statutory case of a periodic monetary payment. The responsibility for the determination of the profit as well as the decision regarding how that profit should be appropriated is assigned to different bodies depending on the legal system: while in Europe and Brazil the general meeting is generally authorised to undertake these functions,⁵⁹ in the US the members of the *board* have control over the payment of dividends on the basis of a *surplus* or *net profit test*.⁶⁰ From these starting points, many and various divergences are possible.

The most common modification in all of the examined legal systems can be found in the granting of preferential rights to the payment of dividends, typically the right to a fixed percentage of the par value of the preference shares. The preference shareholder can be provided with such

⁴⁸ Aktiengesetz (German Stock Corporation Act) §139 para.2.

⁴⁹ Law No.6404/76 (DOU December 17, 1976) Art.15 para.2.

⁵⁰ Code de Commerce Art.L.228-11 para.3.

⁵¹ AktG (Aktiengesetz—Austrian Stock Corporation Act) §12a para.2.

⁵² U. Hüffer in Hüffer, *Aktiengesetz*, 10th edn (Munich: Beck, 2012), §139 note 5 and following.

⁵³ Law No.6404/76 (DOU December 17, 1976) Art.17.

⁵⁴ N. 2190/1920 Art.3(5).

⁵⁵ See AktG (Aktiengesetz—Austrian Stock Corporation Act) §12a.

⁵⁶ See Code de Commerce Art.L.228-11 para.1.

⁵⁷ J. Moulin, “Les actions de preference” [2005] 189 *Petites Affiches* 24, 40.

⁵⁸ Couret and Le Nabasque, above fn.32, paras 410, 451.

⁵⁹ Concerning Brazil, see Law No.6404/76 (DOU December 17, 1976) Art.132, II; for France see Code de Commerce Art.L.232-12 para.1; for Germany see Stock Corporation Act §119 para.1 No.2 and GmbHG (Limited Liability Companies Act) §46 No.1; for Switzerland see Code of Obligations Art.698 s.2 No.4; for the UK see French, Mayson and Ryan, above fn.45, 288 and following.

⁶⁰ See e.g. Delaware General Corporation Law s.170; Revised Model Business Corporation Act s.6.40(a).

a preference in the place of or in addition to a normal profit share.⁶¹ There are a number of important distinctions between such preference dividends and the contractual claims of a creditor to interest payments:

1. When viewed from a procedural perspective, shareholder rights to preference dividends only crystallise on the taking of appropriate actions by the company's governing bodies in all of the examined legal systems. The pre-requisites for such a crystallisation under the German § 140 AktG (Aktengesetz—Stock Corporation Act) are the determination of the balance sheet profit as well as an appropriate resolution of the general meeting to distribute dividends. Similar requirements apply under French law⁶² and British law.⁶³ However, preference shareholders can be given the right to demand such a distribution of profits (e.g. in France⁶⁴). In the US payments to the holders of *preferred stock* are only permitted, like all dividend payments, on the basis of a board declaration.⁶⁵ This is equally true of the—seldom seen—*mandatory dividend*, despite the unusual feature that the contractual basis of the mandatory dividend does not leave the board with any decision-making power.⁶⁶ If dividends are not paid—due to objective impediments or the exercise of discretion by the governing bodies—a cumulative right to back-payments is permitted in all examined legal systems.⁶⁷
2. The legal situation is not uniform with respect to the question of whether such a preference dividend can be paid when no corresponding profit is reported on the balance sheet. The European jurisdictions—Germany, France, UK—require that profits sufficient to cover the payment of the preference dividends are declared and determined.⁶⁸ Otherwise the preferences can simply accumulate and be paid from future profits. This broadly corresponds with the prohibition on the payment of preference dividends from protected capital in these “legal capital” jurisdictions.

In contrast, a different regulatory technique can be found in US law. Here the seldom seen *mandatory dividends* are so designed, that the payment of preference dividends is tied to the

⁶¹ Germany (compare Hüffer, above fn.52), France (P. Raimbourg and M. Boizard, *Ingénierie financière, fiscale et juridique*, 2nd edn (Paris: Dalloz, 2009), para. 11.132), Greece, where the preference shareholders have priority with respect to the distribution of the first dividends, priority with respect to the distribution of any liquidation proceeds and the right to cumulative dividends (N. 2190/1920 Art.3(1, 2)); in the UK it is assumed that only the preference should be paid, in the US: *participating preferred stock*, see Cox and Hazen, above fn.44, §18:10.

⁶² In Brazil the non-voting preference shareholders must normally be guaranteed a substantial share of profits in any event. See Law No.6404/76 (DOU December 17, 1976) Art.17.

⁶³ Code de Commerce Art.L.232-12 para.1.

⁶⁴ Ferran, above fn.30, 150 and following, 237.

⁶⁵ Couret and Le Nabasque, above fn.32, para.417.

⁶⁶ Delaware General Corporation Law s.170; Revised Model Business Corporation Act s.6.40(a).

⁶⁷ B. Black, *Corporate Dividends and Stock Repurchases*, Suppl. (St Paul: West, 2013), §5:2; Cox and Hazen, above fn.44, §20:4; Fletcher, *Fletcher Cyclopedia of the Law of Corporations*, Suppl. (June 2011), §5445.

⁶⁸ See, for the UK, Ferran, above fn.30, 154; for France see Moulin, above fn.57, 24, 28; for Germany see Hüffer, above fn.52, and for the planned removal of the statutory obligation to make back-payments in the 2012 Bill to amend the Stock Corporation Act see U. Seibert and L. Böttcher, “Der Regierungsentwurf der Aktienrechtsnovelle 2012” [2012] *Zeitschrift für Wirtschaftsrecht* (ZIP) 12, 17.

⁶⁹ See, for France, Moulin, above fn.57, 24 (38); for Germany see Stock Corporation Act §57 para.3 and Hüffer, above fn.52, §139 note 2; see, for the UK, Companies Act 2006 s.830 and following, Ferran, above fn.30, 151.

determination of profits and accumulates accordingly (*cumulative-if-earned*).⁷⁰ In addition, the payment of dividends in any event relies largely on the judgement of the *directors*, who are required by the *business judgment rule* to consider the funding requirements of the business in arriving at their decision.⁷¹ Otherwise, as is the case for all dividends, either a *net surplus* or *net profit* is required in order to be able to pay dividends.

It appears to be typical in many legal systems, especially in France, that the (preference) shareholders participate in the losses. In France, participation in the losses is even considered to be a non-negotiable essential feature of a partnership/company although the scope of this can be limited.⁷² In any case, in the European legal systems,⁷³ losses must first be set off against subsequent profits before dividend payments can be made. However, the participation in current losses is often averted due to the cumulative back-payment of preferences. German law even goes so far as to award preference shareholders—in contrast to British law⁷⁴—with the same priority as creditors in respect of claims to unpaid (accumulated) profits, albeit only with those creditors holding the most subordinate debts in insolvency.⁷⁵

It is not only ongoing monetary payments that can be very differently designed; participation in the proceeds of liquidation can also vary enormously. One example is the complete exclusion from such a participation, which is permitted under Swiss law for the holders of dividend rights certificates.⁷⁶ These investors receive the right to participate in current profits on the basis of an earlier payment and therefore are not taken into account in a liquidation. Under German law it is debated whether shareholders can be completely excluded from participation in the proceeds of liquidation (this is now accepted most notably for not-for-profit organisations).⁷⁷ Under French law an interesting hybrid exists: the *actions de jouissance*, which are created by the early repayment of the capital contribution and accordingly no longer secure the right to the repayment of the capital contribution in liquidation but entitle the holders to participate in any liquidation surplus.⁷⁸

More common with preference shareholders, however, is the preferred repayment of the invested capital (in so far as this has not been eroded by an agreed participation in losses) in the liquidation of the company, as it is for example the case in France⁷⁹ or in the UK with regard to

⁷⁰ Cox and Hazen, above fn.44, §18:8; J. Moye, *The law of business organizations*, 6th edn (New York: Thomson Delmar Learning, 2005), 311.

⁷¹ *In re Tube Methods, Inc.*, 73 B.R. 974 at 977 (Bankr. E.D. Pa. 1987).

⁷² This principle is laid down in Code Civil Art.1844-1 para.2 which prohibits the so-called “*Societas Leonina*”, see Merle, above fn.23, para.56, 714; Couret and Le Nabasque, above fn.32, para.415.

⁷³ The US law regarding *nimble dividends* is different. Cf. Delaware General Corporation Law s.170(a)(2); New York Business Corporation Law s.510(b).

⁷⁴ Ferran, above fn.30, 155.

⁷⁵ BGHZ (*Entscheidungen des Bundesgerichtshofs in Zivilsachen*), 185, 206 No.20 and following. The plan of the former Federal Government to abolish the current law, which provides for mandatory back-payments of preferences as part of the 2013 Bill to amend the Stock Corporation Act, was prevented by the German Federal Election in 2013. It is unknown whether the new Federal Government will continue to pursue this plan.

⁷⁶ Swiss Code of Obligations Art.657.

⁷⁷ Hüffer, above fn.52, §271 note 2.

⁷⁸ See Code de Commerce Art.L.225-198 and Art.L.225-199.

⁷⁹ Raimbourg and Boizard, above fn.61, para.11.135.

the British non-*participating preference shares*.⁸⁰ In this way it can be ensured that preference shareholders remain subordinate to creditors but enjoy priority within the group of equity-holders.

US law allows great freedom in this regard. The starting point is simply that there must be a group of shareholders who are entitled to share in the liquidation proceeds. Whether and to what extent a share in the proceeds of liquidation can be awarded to other classes of shares depends on the rights attached to the securities, which is purely a privately determined matter.⁸¹ It is worth emphasising that the class of shareholders with a right to the proceeds of liquidation does not necessarily have to be the same as the required class of shareholders with unlimited voting rights.

Deviations from the debt model permitted by contract law

Proprietary participation rights

The purely contractual character of a right to an amount payable is, from the point of view of most of the examined legal systems, a fundamental indicator of debt. The question whether and to what extent contractual creditors can be given proprietary participation rights in a partnership or company must be answered in the negative. In Germany, this is due to the concept of complete control by partners/shareholders over their legal entity. Even if creditors are provided with rights to information or if their consent must be sought, then to this extent the borrower is simply contractually bound. This does not entail any proprietary entitlement to rights under partnership/corporate law. British law provides similarly: only *members* can be given the right to vote on company resolutions.⁸²

The legal comparison shows, however, that this sharp distinction is not universally accepted. The *Code de Commerce* grants participation rights and the right to be heard at the general meeting of a *Société Anonyme* to representatives of debenture holders.⁸³ The law of the state of *Delaware* goes even further, as section 221 makes it possible for the company statute to grant debenture holders all voting rights, information rights and other participation rights to which a *shareholder* can be entitled.⁸⁴ This legal possibility is seldom used in practice—and then these rights only become effective in the event of *default*. However the example illustrates how very unsustainable the distinction between “absolute” corporate law rights and “relative” contractual rights appears to be.

Longevity of the right

A further standard feature of debt is the limited term of the obligation. Typically, an end-date is set although the creditor as well as the borrower can be granted the right to demand or to make early repayment of the capital. This can be linked to certain events or be connected with a special payment.

⁸⁰ Ferran, above fn.30, 152, 175 and following.

⁸¹ Cox and Hazen, above fn.44, §18:4.

⁸² Companies Act 2006 s.281 and following.

⁸³ Code de Commerce Art.L.228-55 para. 1.

⁸⁴ Chapter 1—General Corporation Law—Delaware Code s.221 Voting, inspection and other rights of bondholders and debenture holders.

For the comparison with equity, the question appears meaningful whether a repayment of the debt can be ruled out in the long term or whether it can at least be made dependent on a termination by the borrower. That is the case in several legal systems. The *perpetual bonds* of British law are paradigmatic and they are now not only explicitly accepted in practice but also in law (section 739 Companies Act 2006).⁸⁵ French law is also heading in this direction. It only provides for a redemption of *titres participatifs* on a liquidation of the company and it recognises a further form of “perpetual bonds” with the *titres subordonnés à durée indéterminée*.⁸⁶ In both cases the borrower can be given the right to repay the credit ahead of time. Ultimately, the “perpetual bond” has now also found acceptance as a financial instrument under German law and is provided for under Brazilian legislation.⁸⁷

Participation rights

For the holders of debt instruments, procedural rights are generally prescribed by the terms of the bond or other contractual agreement. Such rights can vary from simple rights to information, to a situation where the consent of the holder must be sought, to other rights to intervene in the management of the business. The US practice of covenants, in particular, means that a full range of possibilities for influence is available, and other legal systems also accept that these rights are fundamentally permissible. In contrast, these rights of influence can only be anchored in the statute under US law (see above).⁸⁸ The only limitations are to be found in general legal principles (for example, under British law, the boundary of *illegality*, *undue influence* and *public policy*).⁸⁹ It is important to be aware of the fact that in some legal systems the granting and extension of control rights to creditors results in a re-classification of the contract: French law considers—assuming participation in losses—a lender with control rights (lender’s consent must be sought) to be a silent partner.⁹⁰

Noteworthy differences between the examined legal systems ultimately show themselves when one poses the question to what extent positive law of itself provides creditors with rights to information and participation rights. French law goes a long way as it provides the representatives of debenture holders with participation rights and rights to be heard at the shareholders’ general meeting.⁹¹ The holders of *titres participatifs* (only repayable on liquidation of the company) also have—in contrast with the holders of *titres subordonnés*—the same rights to information as shareholders.⁹² The situation is similar for the holders of convertible notes and options.⁹³

⁸⁵ J. Walmsley, *New financial instruments*, 2nd edn (Oxford: John Wiley & Sons, 1998), 255.

⁸⁶ See Code de Commerce Art.L.228-36 para.1 for the *titres participatifs* and M. Cozian, A. Viandier and F. Deboissy, *Droit des sociétés*, 25th edn (Paris: LexisNexis, 2012), para.1007 for the *titres subordonnés à durée indéterminée*.

⁸⁷ P. Sester, “Hybrid-Anleihen—Wirtschaftliches Eigenkapital für Aktiengesellschaften” [2006] *Zeitschrift für Bankrecht und Bankwirtschaft* 443, 450 and following.

⁸⁸ Delaware General Corporation Law s.221.

⁸⁹ R. Burgess and G. Morse, *Partnership Law and practice in England and Scotland* (London: Sweet & Maxwell, 1980), 131.

⁹⁰ CA Paris, 25e ch. A, 29 mars 2002, *Droit des sociétés* 6/2003, 10.

⁹¹ Code de Commerce Art.L.228-55 para.1.

⁹² Code de Commerce Art.L.228-37 para.5.

⁹³ Code de Commerce Art.L.228-105 para.1.

Most notably, it is not clear to what extent the holders of profit-dependent rights have, by virtue of positive law, a right to information from the debtor regarding the extent of remuneration or any participation in the proceeds of liquidation. In this regard, German law sees general rights to information under private law as a basis for such access to information.⁹⁴

Modifications of financial entitlements

The ability to privately configure the financial entitlements is naturally of high importance from a business finance perspective. This affects three elements: the current return on capital, the repayment of the capital and the ranking of these claims in the event of the insolvency of the debtor.

A fixed agreed interest rate constitutes the typological normal consideration for debt. However, freedom of contract means that numerous divergences from this general principle can be agreed upon. This means, first, that a loan can be granted in return for a share of the profit of the enterprise (participating loans, income bonds, etc.). Therefore, in all examined legal systems a share in profits does not necessarily mean that a partnership or company has been formed.⁹⁵ This means:

1. These legal systems must, on the one hand, find a distinction between a participating loan and a silent partnership. This is particularly clearly formulated in French law where the (existing or lack of) participation in losses forms the borderline between a partnership/company and a loan.⁹⁶ British law acts on the assumption that a share in profits constitutes prima facie evidence for the existence of a partnership.⁹⁷ In contrast, German⁹⁸ and Austrian⁹⁹ law recognise the existence of a silent partnership without any participation in losses; Swiss¹⁰⁰ law, on the other hand, recognises even participating loans with a share in losses. This prevents the distinction being made according to objective features and leads to a problematic consideration of the *affectio societatis* of the parties.¹⁰¹ Greek law simply prohibits a share in profits for loans that exceed the statutorily prescribed maximum interest rate.¹⁰²
2. Most legal systems contain the further feature that for companies, the shareholders' claim to profits is reduced by the prior flow of a share in profits to the holders of debt. The flip-side of this is that, for companies limited by shares, the granting of profit-dependent debentures and participation rights is often dependent on the approval of the general meeting of the shareholders. However, this is not

⁹⁴ Weidenkaff in Palandt, *Kommentar zum Bürgerlichen Gesetzbuch*, 73rd edn (Munich: Beck, 2014), Introduction to §488 note 20.

⁹⁵ For the UK cf. Partnership Act 1890 s.2(3)(d); Banks, above fn.19, 87 and following.

⁹⁶ Merle, above fn.23, para.714.

⁹⁷ Partnership Act 1890 s.2(3): "The receipt by a person of a share of the profits of a business is prima facie evidence that he is a partner in the business, but the receipt of such a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business."

⁹⁸ Handelsgesetzbuch (German Trade Act) §230 para.2.

⁹⁹ See Austrian Commercial Code (UGB) §181 s.2; Krejci and van Husen, above fn.26, 54, 62.

¹⁰⁰ Bundesgericht, July 18, 1973, BGE 99 II 303, 306, Erwägung 4c).

¹⁰¹ Hopt, in: Baumbach/Hopt, above fn.22, §230 note 4.

¹⁰² A. Georgiades, *Law of Obligations* (P.N. Sakoulas, 2007), 579.

- compulsory, as a look at the practice in the UK¹⁰³ and the US demonstrates.¹⁰⁴ Greek law takes a different approach and prescribes that the profit claims of the shareholders must be satisfied before the profit claims of bond creditors.¹⁰⁵
3. Freedom of contract means, moreover, that further hybrid forms between fixed interest payments and a share in profits can be used. These can comprise a combination of guaranteed interest payments and a share of profits or an agreement that makes the payment of fixed interest dependent on the existence of sufficient annual profit. This can mean that interest that is unpaid due to a lack of profits falls away entirely or that it accumulates and is paid at a later date when sufficient profits are there or that payment is postponed until liquidation. In Britain the practice with bonds is that, when profits are not sufficient for the payment of interest, creditors' claims may be satisfied through the issue of shares (without draining corporate assets).¹⁰⁶
 4. Ultimately, creditors can also participate in losses, for example, within the framework of participation rights, as they are usually seen in Germany¹⁰⁷ or Austria¹⁰⁸ (and which are commonly not regarded as silent partnerships). In Switzerland the legal notion of the participating loan is available for this purpose.¹⁰⁹ Further, other reference values can also be used as the basis for calculating the remuneration, for example, the result of a certain branch of the business, turnover figures or an index.

The debt model assumes a repayment of a fixed sum at the end of the term of the loan of capital. Once again, significant modifications can be agreed upon. This is true first of the participation in the latent gains of the enterprise which can be granted to a creditor (for example, in Germany¹¹⁰ and Austria¹¹¹) in the realm of silent partnerships or equally well within the realm of participation rights. A share in latent gains is seldom granted to those with contractual entitlements in those legal systems that offer a large amount of configuration freedom for equity instruments.

By the same token, a creditor's share in losses can lead to a reduction of the investment and therefore of the amount to be paid back. The Greek "foundation bonds" belong once again to a different category. They allocate a share in profits to the founder on a contractual basis but they do not require any capital investment in return nor do they afford a repayment of such.¹¹²

The legal comparison reveals that the differentiation of the ranking of the different financial instruments in the event of insolvency plays a very significant role for the contractual practice.

¹⁰³ Companies Act 2006 ss.550(b), 551(1)(b) (e contrario).

¹⁰⁴ For the US see Cox and Hazen, above fn.44, §18:1, 18:3.

¹⁰⁵ N. 2190/1920 Art.3b.

¹⁰⁶ Compare J. Hannam, "Will it All End in Tiers? The Importance of Tier One Capital" [2008] *The Tax Journal*, August 11, 2008, 9, 10.

¹⁰⁷ T. Beuchert and P. Redeker, "Eigen- und Fremdkapital im Steuer- und Gesellschaftsrecht Deutschlands" in Schön, above fn.14, 289, 311.

¹⁰⁸ See Krejci and van Husen, above fn.27, 54, 60.

¹⁰⁹ Bundesgericht, above fn.101, BGE 99 II 303, 306 et. seq., Erwägung 4c).

¹¹⁰ Compare silent partnerships Schmidt, in: Schmidt, above fn.22, §230 note 79; cf. *jouissance* rights M. Habersack, in W. Goette and M. Habersack (eds), *Münchener Kommentar zum Aktiengesetz*, 3rd edn (Munich: Beck, 2011) Vol. 4, §221 note 114.

¹¹¹ Krejci and van Husen, above fn.26, 54, 56 et. seq.

¹¹² N. 2190/1920 Art.15.

The starting point is the same everywhere: all debt instruments are to be satisfied in priority to all equity instruments. The rules that exist in some legal systems for shareholder loans are only apparently an exception: such loans are statutorily or judicially given a lower ranking than the remaining debt: however shareholder loans, due to their character as debt, must be satisfied before actual equity instruments.

Another special situation arises under British law, where profit-dependent (debt) receivables *ipso iure* and mandatorily possess a lower priority than all other debt instruments.¹¹³ German law contains a somewhat less strict provision, enabling the repayment of a silent partner's investment (but not that of a creditor under a participating loan) within one year before insolvency to be contested; nonetheless this does not alter the equal ranking with the other parties entitled to claim in the insolvency.¹¹⁴

However, the bonds practice has found ways to create further levels of priority within debt. It is possible to establish by contract that holders of particular bonds rank behind all other creditors or at any rate lower than a specific group of or certain individual creditors. This subordination can be limited to the repayment of the capital and therefore does not extend to the arrears of interest. This is true in Germany and Austria¹¹⁵ namely for obligations arising from participation certificates. French law offers a particularly comprehensive practice as it provides for fine distinctions in ranking between *prêts participatifs*, *titres participatifs*, *titres subordonnés* and lastly *titres super-subordonnés*, which has a significant impact on the banking and accounting practice.¹¹⁶ US law grants freedoms that are equally far-reaching.¹¹⁷ British legal practice has taken some time to find appropriate legal regulations for *subordinated bonds*, in particular in order to deal with the subsequent lifting of the subordination (through a “contract at the expense of third parties”).¹¹⁸

In the end result, it is apparent that the classic ranking of superior debt and inferior equity yielded long ago to a configurable “multi-level system”, in which the distinctions are gradual rather than substantial.

Likewise, all examined legal systems are conversant with bonds that carry the right to receive equity in the enterprise, be it through a conversion of the bond into a share (*convertible bonds*), or through the exercise of an option that exists alongside the bond (*bonds with warrants*).¹¹⁹ Corresponding configurations also exist for individual loans or participation certificates. The issuer is often given a *call option* for the conversion (reverse convertible) or the conversion is set in advance to occur at a certain point in time (*mandatory convertible bonds*). In US law *convertible debt* and *convertible stock* are to a large extent matched against each another in this

¹¹³ Partnership Act 1890 s.3. Cf. P.R. Wood, *Comparative law of security interests and title finance*, 2nd edn (London: Sweet & Maxwell, 2007), 321.

¹¹⁴ Insolvenzordnung (German Insolvency Act) §136.

¹¹⁵ Krejci and van Husen, above fn.26, 54, 56 and following.

¹¹⁶ The statutory basis for these financial instruments is found in Code monétaire et financier Art.L.313-13 (*prêts participatifs*), Code de Commerce Art.L.228-36 (*titres participatifs*) and Code de Commerce Art.L.228-97 (*titres subordonnés* including *titres super-subordonnés*). For more details on the latter see M. Galland, “La subordination de dernier rang: régime et finalités des titres supersubordonnés” [2006] 10 *Bulletin Joly Sociétés* 1111.

¹¹⁷ B. Dravis, “Financing a Business” in R. Brown and A. Gutterman (eds), *Emerging Companies Guide: A Resource for Professionals and Entrepreneurs* (Chicago: American Bar Association, 2005), 185, 211.

¹¹⁸ Compare E. Ferran, *Company law and corporate finance* (Oxford: OUP, 1999), 550 and following.

¹¹⁹ For the UK cf. Ferran, above fn.30, 521.

way.¹²⁰ In all of these cases, the European legal systems protect shareholders from a dilution of their rights by requiring a resolution of the general meeting and by giving shareholders subscription rights.¹²¹ In a further step, the law or the contractual provisions themselves protect bond creditors from a subsequent dilution of their rights due to the issue of further financial instruments.¹²²

Summary

When one summarises the results of the legal comparison of the demarcation between equity and debt under corporate/partnership law and contract law, several points can be identified:

1. In most legal systems, the starting point is the establishment of equity holdings in the partnership agreement/company statute as well as the establishment of debt holdings in a loan contract. The possibility of enshrining certain rights for creditors in the company statute (*Delaware*) remains the rare exception.
2. In some legal systems, shares continue to be based on a permanent membership, but in more and more jurisdictions they can be issued with a limited life and with the ability to terminate. On the flip side, many legal systems today enable a creditor's right to repayment under a bond to be permanently ruled out.
3. Bond creditors, like shareholders, can receive rights to information and participation rights on a statutory or contractual basis. Voting rights for creditors in the meeting of shareholders/partners are by and large ruled out, but can, however, be emulated under the debt covenant. All legal systems recognise non-voting shares, but the extent to which they may be issued is partially limited, and each legal system assesses the need for financial compensation differently.
4. The distribution of profits to an equity-holder is dependent on a corresponding resolution of the general meeting or the *board*. This is also true of preference shares with fixed or minimum rates of return, which typically accumulate in the absence of a dividend payment. Bond creditors generally receive a fixed enforceable interest yield. In so far as they are given the right to a profit-dependent payment, the starting point is that this is dependent only on the existence of a balance sheet profit, but it is sometimes equally dependent on a formal determination of profit or even on a company resolution to make a distribution.
5. In so far as it is the case that in some (predominantly European) legal systems, dividends may not be paid from the statutory capital, the financier's formal membership of the partnership/company is critical.
6. The share of the proceeds of liquidation payable to shareholders and creditors can to a large extent be freely determined.
7. Insolvency is governed by the fundamental distinction between prior-ranking debt and subordinate equity. However, further levels of priority can be introduced within

¹²⁰ J.D. Bauman, A.R. Palmiter and F. Partnoy, *Corporations: law and policy*, 6th edn (St Paul: Thomson/West, 2007), 220.

¹²¹ For the UK cf. Companies Act 2006 ss.550(b), 551(1)(b).

¹²² For the UK cf. Ferran, above fn.30, 521.

debt as well as within equity, which converts the clear dichotomy into a graded hierarchy of financial instruments.

Equity and debt in tax law

The three-fold significance of the capital distinction

In German and foreign tax law, but also in the law of double tax treaties and other international sets of rules, it is generally recognised that the financing of entrepreneurial activity with equity and debt gives rise to different legal consequences. Three elements are at the forefront of this consideration:

1. In national income tax law, the partners in a partnership are subjected to a joint commercial profit assessment whereas the creditors of the enterprise are individually taxed with regard to their return on capital and accordingly (in principle) receive investment income rather than commercial income.
2. A fundamental feature of national corporate tax law is the non-deductibility of dividends and other forms of return on equity at the level of the tax-paying entity. This brings about a double taxation of company profits, which gives rise to the need for special relief mechanisms for dividend income and for capital gains on the sale of shares as a second step at the level of the shareholder.
3. In international tax law it is generally the case that the country of source is assigned the right to tax earnings from equity, whereas the right to tax earnings from debt is predominantly assigned to the country of residence. Against this general background, there are particular problems associated with cross-border shareholder loans.

The concept of income, the realisation principle and the taxation of companies/partnerships

If one looks more closely, one can see, however, that the basic structure of income as an economic value does not necessarily require a distinction between equity and earnings from equity on the one hand or between debt and earnings from debt on the other hand. This is true, first, for the “Schanz-Haig-Simons” (SHS) income tax on the basis of the net increase in wealth.¹²³ Whether a person enjoys an increase in wealth in the form of interest or in the form of a profit share is fundamentally of no significance within the framework of a uniform and “synthetic” income tax: both forms of finance can be subject to income tax without the formation of further categories for the respectively generated earnings. The fact that a profit share distinguishes itself from fixed interest due to its risk profile, and in particular due to its higher volatility, is simply depicted in that the income actually generated is taxed according to its quantity, and the quality of that income as dividends or interest plays no role in its measurement. The same applies to profits generated through the sale of financial instruments in the market: if and to the extent that a taxation system makes all *capital gains* subject to income taxation without consideration of the

¹²³ J. Lang, “The influence of tax principles on the taxation of income from capital” in P.H.J. Essers and A. Rijkers (eds), *The notion of income from capital*, EATLP International Tax Series (Amsterdam: IBFD, 2005), Vol.1, 3 and following.

object sold, then it does not matter whether the asset sold is an instrument of equity or debt. A “pure” taxation system on the basis of a comprehensive concept of income is, against this background, based from the outset on financial neutrality.

This result does not change if the legislature moves from a traditional income tax to a consumption tax.¹²⁴ A consumption-style income tax is discussed in two forms: the cash-flow tax and the tax exemption for the risk-free rate of return.¹²⁵ In the former case, those components of income (provisional) that are reinvested for the purposes of generating income are tax-free, whereas those components of income that are withdrawn and used for private consumption are subject to tax. For the deferral of tax it does not matter whether the reinvested or consumed income component is based on the use of equity or debt. In the case of an allowance for a nominal return on capital, the relief from the tax for the intertemporal use is achieved through the relief from taxation of a statutorily prescribed “protected interest rate” on the employed capital. In doing so the question of whether such earnings are based on equity or debt can in each case remain open, as long as the level of the statutorily protected interest rate is set consistently for both types of capital.

This also applies within the framework of a dual income tax,¹²⁶ if, for all kinds of income from capital, a certain “notional interest” is subject to a proportional (low) tax rate: it is not significant for the use of these principles whether amounts in excess of this norm, which are subject to regular taxation, arise from deviations from the general market interest rate for debt (for example from risky *high-yield bonds*) or are based on the volatility of equity-based profit shares.

The ubiquitous necessity to differentiate between equity and debt is therefore not justified by the concept of income as such. The need for differentiation derives more from the deviations from this uniform state that have evolved in domestic and international tax systems. These can be found in income tax law primarily in the special rules regarding the immediate attribution of income generated by the partnership to the partners and additionally in the different legal consequences for business income and other income—based on private investment. In corporate tax law, the doubling of the levels of taxation (shareholder and company) is at the forefront of the differentiation between equity and debt. In international tax law the distinction ultimately concerns the unilateral, bilateral and multilateral assignment of taxation rights. Whether and to what extent the national tax law bestows particular advantages or disadvantages on the classification of forms of finance as equity or debt thus naturally has an effect on the drafting practice in individual jurisdictions.

Against this background, an analysis of the purpose and sustainability of the differentiation between equity and debt is in order. The following analysis focuses on the legal consequences of the distinction and looks separately at general income tax law, corporate tax law and international tax law. In doing so, an examination should be made in each case, after a legal comparison has been conducted as to whether the statutory or judicial moulding of the situation

¹²⁴ Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation (Meade Report)* (London: Allen & Unwin, 1978), 30 and following.

¹²⁵ See most recently: *The Mirrlees Review*, above fn.6, 418 and following; R.H. Gordon, “Commentary on Tax By Design: The Mirrlees Review” (2011) 32 *Fiscal Studies* 395, 397 and following; Lang, above fn.123, 18 and following.

¹²⁶ 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*, ZEW Economic Studies (Heidelberg: Physica-Verlag, 2008), Vol.39.

is functionally and appropriately based on the relevant legal features or if a re-adjustment appears to be due.

The equity—debt demarcation in individual income tax law

The legal consequences of the classification of capital for income tax purposes

As a first step the legal consequences that individual income tax law (excluding the taxation of dividends and corporate tax law) attaches to the differentiation between equity and debt should be considered. Paradigmatic for the posing of this question is the situation of a sole proprietor of a business who receives fresh capital from another person for the business. For this, traditional debt comes into consideration, for example, the granting of an interest-bearing loan, but also traditional equity, for example, the acquisition of a participation in the business. Hybrid finance resides between these two ends of the spectrum, namely the granting of a participating loan or a silent partner's investment. Under the SHS concept of income, these classifications should not play a role.

This is where the impact of the realisation principle—the most important limitation of the comprehensive income concept—comes into play. It allows the taxation of increases in wealth at the level of the taxpayer only when this person—through the actual receipt of earnings or a market transaction—enjoys a liquid increase in their ability to pay. However, national tax systems regularly deviate from this principle in the taxation of partnerships and comparable multi-person entities.¹²⁷ If and to the extent that a partnership is not itself subject to income tax or corporate tax, then the profit accrued at the level of the partnership in the taxable period must be attributed to the partners in order to ensure that this profit is fully taxed and that taxation cannot be deferred.¹²⁸ From the perspective of the partner, this is a breach of the realisation principle, because a share of the income is taxed in the hands of the partner although the partner still has no access to that profit share—depending on the legal position and the contractual agreement between the relevant parties.

National legal systems therefore need to determine for which investors of capital such a direct partial attribution of the “jointly” generated revenue should be prescribed. If a taxpayer proves to be a partial owner of a jointly operated enterprise, then the taxpayer must accept that a proportionate share of the profit generated in this enterprise will be directly attributed to him. This can in fact prove to be useful from the point of view of the affected parties, for example, if the direct attribution of a share of income to a certain (tax-advantaged) part-owner simultaneously precludes this share of income from being attributed to others for tax purposes.¹²⁹ At the end of the day, the revenue of the multi-person entity is as a rule procedurally jointly established.

¹²⁷ In Germany the “wirtschaftlich vergleichbaren Gemeinschaftsverhältnisse” (*economically comparable relationships*) like the Erbengemeinschaft (*joint ownership of heirs*) or the Gütergemeinschaft (*joint ownership of property by spouses*); in the US, e.g. the *joint venture*.

¹²⁸ W. Schön, “Die Personengesellschaft im Steuerrechtsvergleich” in F. Dötsch et al. (eds), *Die Personengesellschaft im Steuerrecht: Gedächtnissymposium für Brigitte Knobbe-Keuk* (Cologne: Schmidt, 2011), 139, 141 and following.

¹²⁹ See the *Castle Harbour* decision: *TIFD III-E v US (Castle Harbour)*, 459 F.3d 220 (2006) (Attempt to attribute domestic income to foreign investors by alleging a *partnership*; the classification of the legal relationship as a loan led to the result that the payment was seen as a tax-neutral repayment of principal on the part of the domestic debtor).

A creditor, in contrast, is only required to pay tax in respect of income that flows personally to him according to the general rules for the assessment of income¹³⁰; these payments will generally be booked as tax deductible expenses at the level of the recipient of the capital.

A good example for this basic distinction is the decision of the US Tax Court in *Hartman v Commissioner*¹³¹ the result of which would meet with approval in most other jurisdictions:

The Complainant made capital available to a transport enterprise for the operation of a ferry while a bridge was undergoing maintenance. From the profits generated, the capital was to be repaid first of all. The excess profit was to be shared. The Complainant alleged that as a simple *creditor* he is only required to remit tax on the share of profits that flowed to him. However, the Tax Court classified the ferry operation as a *joint venture* of the Complainant and the transport enterprise, resulting in the direct attribution of a proportionate share of the revenue generated.

For income tax law, these types of arrangements lead to the question: for which capital investors does it make sense to assess jointly the results and to allocate a share of the result to the tax-paying part-owners for tax purposes in a direct fashion.

There is a certain deviation from this duality between the “direct attribution” to partners and the use of the general rules regarding the receipt of income for creditors in those states where there is a middle category between fully-entitled partners on the one hand and the mere business creditor on the other, comprised of capital investors who are in fact equity investors but who, due to their limited liability like shareholders or limited liability partners, are subject to the corporate tax law system. A good example is French law, where the income of limited partners or silent partners without unlimited liability is subject to corporate tax at the level of the partnership and the ensuing dividends are caught within the framework of income tax law.¹³² The objective here is also to ensure a timely taxation of the revenue generated in the enterprise, although for limited liability partners this is achieved through making the partnership itself subject to tax.

The distinction between equity and debt has an effect on these forms of investment not through the direct attribution of business income to the investors of equity, but rather through the priority given to corporate tax law. This is also true first and foremost of states like Brazil¹³³ and Greece,¹³⁴ where all partnerships are exclusively subject to corporate tax law from the outset.

The direct attribution of partnership results also has consequences when claiming that investments of capital have suffered a loss in value for tax purposes. A creditor who would like to write down his investment can do this under German law (if the creditor’s right is held as a business asset). A partner in a commercial partnership cannot, however, write off any amount for tax purposes from the economic property which is the share in the partnership. Similarly, in the US the question arises whether the investor of capital can, as a *creditor*, write-off the value

¹³⁰ According to whether the capital investment is treated as part of the assets of the company on an *accruals basis* or *cash basis*.

¹³¹ *Hartman v CIR*, Tax Court Memo 1958-206 17 TCM 1020 (1958).

¹³² Code Général des Impôts Art.206(4), Art.108.

¹³³ Law No.4506/64 (DOU November 30, 1964) Art.41 in conjunction with Decree No.3000/99—DOU March 29, 1999; DOU June 17, 1999, Art.150 §1 II.

¹³⁴ KFE (Kodikas Forologias Eisodimatos-Income Tax Act) Art.10(1) as amended by Law 4110/2013 Art.3(1). The peculiarity of Greek tax law is that the net profit of partnerships at the partnership level is in some cases independently taxed at the rate of 10%.

of his investment as a *bad debt* or whether as a *partner* he has to wait for a full liquidation of the partnership.¹³⁵ In any case, intermediate solutions can be found. French law directs that business losses of the partnership be attributed immediately to the relevant partners; in addition, a partner involved in business operations is allowed to write down the value of his share in the partnership.¹³⁶

The legal comparison further illustrates that the question of the classification of finance as equity or debt arises when different forms of capital and the resulting returns are assigned to different types of income and for this reason are subject to different legal consequences.

The legacy of the dualism of revenue types is defining for German as well as Austrian¹³⁷ income tax law as regards the differentiation between equity and debt. The starting point is the fact that income tax law only makes business income subject to the “accruals method” and thus directs a balance sheet-supported assessment of revenue for this type of income, whereas revenue received by creditors is fundamentally received as (private) revenue from capital and therefore is to be assessed, as a rule, as the excess of the income over the related expenses (“cash-flow method”).¹³⁸ The profit share of the equity investor in the commercial partnership is thus not only directly attributed to the investor; it is assessed at the level of the partnership through the “accruals method”. From the point of view of the creditor, not only is a direct attribution of the returns missing; in addition the rules regarding revenue in excess of expenses are to be used, so long as the capital investment is not itself a business asset.

The differentiation between the types of revenue intensifies when profits on disposal are subject to tax depending on the classification of the type of capital. Germany has created a problematic tradition for itself here by distinguishing between “private income” and “business income.” This includes a tax liability for capital gains (but also the recognition of capital losses) when a complete enterprise or an interest in a commercial partnership is transferred. By contrast, there was no capital gains taxation for holdings which were in the hands of creditors until the taxation reform of 2009. A decisive reason for the classification, specific to German law, of the “atypical silent partnership” (where the silent partner shares in the hidden reserves or latent gains of the enterprise) as a commercial partnership, is the desire to ensure that capital gains, which arise frequently for these partnerships, are subject to tax in the same way as a limited partner’s interest in a partnership. Since 2009, the situation under German law has become further complicated: the disposal of “private” capital investments is indeed subject to tax, but is subject to the special tax rate of 25 per cent; in the private domain a write-down of the value is still precluded and losses on disposal can only be set off against profits of a similar type.¹³⁹

Other states have taxed *capital gains* for a long time and indeed for both commercial as well as private investments, but they frequently have special rules for the assessment of the gain for each type of income arrangement and special taxation rates. The dichotomy between debt and equity frequently proves itself to be significant here as well. The US courts have in several

¹³⁵ *Hambuechen v CIR (Hambuechen)*, 43 TC 90 (1964); *Rouse v CIR (Rouse)*, Tax Court Memo 1964-297, 23 TCM 1823 (1964); *Hubert Enterprises v CIR*, 125 TC 72 (1998).

¹³⁶ Because the partnership share as a separate economic good is counted among the partner’s business assets, see Code Général des Impôts Art.151 nonies.

¹³⁷ J. Schuch in R. Bertl et al. (eds), *Eigenkapital* (Vienna: Linde, 2004), 217, 219 and following.

¹³⁸ EStG (Einkommensteuergesetz—Income Tax Act) §2 para.2.

¹³⁹ EStG (Einkommensteuergesetz—Income Tax Act) §20 para.6.

decisions rejected the argument that termination payments for participating contracts should be classified as preferential proceeds from the disposal of shares in *partnerships* or *joint ventures*, and have held that these payments are instead subject to normal taxation as *ordinary income*.¹⁴⁰

Furthermore, attempts have been made in several legal systems to limit the off-setting of losses between revenue types. In particular it has been sought to restrict or even fundamentally exclude the compensation of losses from private investments with positive income from other sources. Such a statutory provision makes it necessary to differentiate equity interests and debt interests in partnerships according to their “commercial” character. Such rules can be found currently in British,¹⁴¹ French¹⁴² and US law, whereas the comparable German rule (former §2 para.3 EStG (Einkommensteuergesetz—Income Tax Act)) has since been repealed and only lives on as a limitation to the off-setting of losses from the disposal of capital investments (§20 para.6 EStG).

In German tax law, the classification of revenue as commercial ultimately results in it being subject to the (special) burden of the trade tax. The trade tax treatment of commercial earnings contributes significantly to the current German tax bias against equity as a source of finance.¹⁴³ In contrast, the original trade tax had, since 1936, defined commercial earnings so as to achieve a financially neutral burden, for example, by including all interest on long-term debts and the profit share of (typical) silent partners in the assessment of commercial earnings. The classification of interest received by a partner from loans made to the partnership as “commercial special remuneration”, which was already a part of income tax law in 1934, was a step in the same direction. Against this background, the characterisation of a financial instrument as equity or debt was, from the point of view of trade tax, of little significance at the outset. The legislature has, however, over several decades reduced the trade tax burden for debt in terms of the amounts that must be included as commercial earnings; thus the classification of capital grants as debt or equity currently leads to significant differences in the burden applied by the trade tax.

Various other examples demonstrate that this does not have to be the case. There are states that manage without a trade tax and that rely completely on the charging of land tax for the autonomous financing of local councils (UK)¹⁴⁴; similarly, in the individual states of the US a *commercial property tax* is levied. Other states configure the trade tax so as to be finance-neutral: in France the tax is linked to the operational use of economic assets,¹⁴⁵ in Italy (Italian regional production tax (IRAP)) the added value is the relevant figure for calculations and in Switzerland¹⁴⁶ a corresponding Canton Tax (in Geneva) is levied on the basis of the external sales, the rental value of the real estate used, as well as the annual payroll. A local tax that is aligned only with the annual payroll is, in Austria, the only surviving remnant of the classic trade tax. None of these local taxes differentiate between equity and debt.

¹⁴⁰ *Podell v CIR*, 55 T.C. 429 (1971); *S.M.Plumbing v CIR (Plumbing)*, 55 T.C. 702 (1971); see also *Luna v CIR*, 42 T.C. 1067 (1964).

¹⁴¹ ITA s.102 and following.

¹⁴² Code Général des Impôts Art.156(I)(1) bis.

¹⁴³ cf. Handelsgesetzbuch (German Trade Tax Act) §7 para.1 sentence 1.

¹⁴⁴ S. Tivey in M. Arnold (ed.), *Tolley's Property Taxation 2010–11* (London: Tolley Publishing, 2010), 843 and following.

¹⁴⁵ Code Général des Impôts Art.1467 para.1.

¹⁴⁶ Compare the rule in Geneva Loi générale sur les contributions publiques Art.302.

Of course no financial neutrality can appear at the regional or local level if the intra-state taxes are linked to the basis of calculation used for the (not finance-neutral) income tax levied at the national level (for example, in the US states or in the Swiss Cantons and Municipalities¹⁴⁷).

A legal comparison of the income tax demarcation criteria

Against this background, in the following section the criteria will be described that are critical for the particularised legal consequences in the examined legal systems.

In all examined jurisdictions, the association of multiple persons for a common purpose is a pre-requisite for the joint taxation of these taxpayers—which also includes the direct attribution of the income generated at the level of the partnership/company. This is achieved in German and Austrian law through the statutory criterion of the “partnership”, which does not include a loan relationship,¹⁴⁸ but other states also draw a demarcation line between a *partner* and a *creditor*.¹⁴⁹ To do so it is necessary to refer to the actual intention of the parties involved on the basis of objective indices.

From the point of view of the choice between equity and debt, the question of whether the granting of capital for a simple stake in the ongoing profits of the business (without participating in losses) of itself justifies the unified assessment and direct attribution of the results generated to the contracting partner is of critical importance. This question is answered overwhelmingly in the negative in the examined legal systems, albeit with varying approaches:

1. French law requires partners/shareholders to participate in losses and to participate in the management of the business at least in the form of control rights¹⁵⁰; otherwise there is no partnership/company but rather a participating loan, which is classified as debt.
2. German as well as Austrian law recognises, alongside participating loans, silent partnerships where there is no participation in losses, but from a tax point of view the direct attribution of revenue to a “business partner” additionally requires that they participate in latent gains including the goodwill¹⁵¹ of the business (and/or the exercise of active participation rights)¹⁵²; the simple commitment of capital in return

¹⁴⁷ In Switzerland this is achieved indirectly via the national law regarding the harmonisation of direct taxes of the Cantons and Municipalities, which sets the basic principles which are relevant for the tax laws of the Cantons and Municipalities and which in its configuration is based on the DBG (Bundesgesetz über die Direkte Bundessteuer—Direct Federal Tax Act).

¹⁴⁸ Dötsch, “Mitunternehmer und Mitunternehmerschaft” in Dötsch, above fn.128, 7 and following.

¹⁴⁹ See e.g. for France the administrative instruction BIC—Champ d’application—Personnes imposables—Sociétés de personnes et assimilées—Sociétés créées de fait. BOFiP-Impôts BOI-BIC-CHAMP-70-20-60-20120912 para.50 and following, available at: <http://bofip.impots.gouv.fr/bofip/3606-PGP.html?identifiant=BOI-BIC-CHAMP-70-20-60-20120912> [Accessed April 7, 2014]. In addition there are comparable multi-person entities, e.g. the “*wirtschaftlich vergleichbaren Gemeinschaftsverhältnisse*” (“economically comparable relationships”) of German law or the (related to a concrete project) joint ventures of US law.

¹⁵⁰ Merle, above fn.23, para.709, 714; an example from tax law jurisprudence provides Conseil d’Etat, 26 Juin 1987, No.50681, available at: <http://www.easydroit.fr/jurisprudence/Conseil-d-Etat-9-7-SSR-du-26-juin-1987-50681-inedit-au-recueil-Lebon-50681/J137286/> [Accessed April 7, 2014].

¹⁵¹ See VwGH February 9, 1982, 81/14/0060. Previously VwGH December 4, 1953, 7/51; September 30, 1955, 1426/53 and later, for instance, VwGH April 29, 1981, 3122/79; February 16, 1994, 90/13/0048; February 24, 2000, 96/15/0062.

¹⁵² Haep in C. Herrmann, G. Heuer and A. Raupach, *Einkommensteuergesetz* (Cologne: Otto Schmidt, 2014, EL 261), §15 note 392.

- for a share of profits is therefore always debt from a tax perspective, irrespective of the classification of the interest as a participating loan or a silent partnership.¹⁵³
3. Greek law in contrast considers even a simple participation in profits to be possible within the framework of a silent partnership, but in any case the border between a silent partnership and a participating loan leads to a corporate tax liability for the undisclosed partnership.¹⁵⁴
 4. In Switzerland a participating loan does not justify a joint assessment of profits for the giver and receiver of capital.¹⁵⁵ Silent partnerships seem to be capable of being formed from a private law point of view but for practical reasons are not used¹⁵⁶ (perhaps also due to the possibility of a participating loan including participation in losses which does not exist in other states).
 5. In the UK the Partnership Act 1890¹⁵⁷ explicitly states that the granting of a loan in return for a share of profits does not of itself establish a *partnership*.¹⁵⁸ Such a classification would also be relevant for taxation purposes.¹⁵⁹ However, a contrary legal consequence flows from the fact that under British law, profit-dependent remuneration paid by the recipient of the capital is not recognised as deductible *interest*.¹⁶⁰ In this respect, for tax purposes, the inclusion of this share of the profit at the level of the entity conducting the business is fundamentally ensured.
 6. The starting point in the US is the fact that a *partnership* or a *joint venture* must be distinguished from a loan on the basis of a number of factors.¹⁶¹ In undertaking this assessment the extent to which the investor of capital is involved in the business risk is the most decisive factor. According to the courts, the investor of equity is “an adventurer in the corporate business, who takes the risk, and profits from success”, whereas the grantor of debt “in compensation for not sharing the profits, is to be paid independently of the risk of success, and gets a right to dip into the capital when the payment date arrives.”¹⁶² In this demarcation it remains unclear, however, if the agreement of a fixed, not especially risky right to repayment of itself justifies the classification of the finance as debt or whether the return on

¹⁵³ Haep, above fn.152, notes 391 and following.

¹⁵⁴ KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Art.10(1).

¹⁵⁵ See Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.a on the one hand, and Bundesgesetz über die direkte Bundessteuer Art.58 para.1 lit.b *e contrario* on the other hand.

¹⁵⁶ Meier-Hayoz and Forstmoser, above fn.47, §15 No.51 and following.

¹⁵⁷ Partnership Act 1890 s.2(3)(d). The advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with the profits, or shall receive a share of the profits arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business or liable as such. Provided that the contract is in writing, and signed by or on behalf of all the parties thereto.

¹⁵⁸ Banks, above fn.19, 87 and following.

¹⁵⁹ Compare HMRC, *Business Income Manual*, BIM72005.

¹⁶⁰ G. Montagu, *Norfolk and Montagu on the Taxation of Interest and Debt Finance* (Haywards Heath, Issue 18, August 2010), para.2.84 and following; D. Southern, *Taxation of Loan Relationships and Derivative Contracts*, 9th edn (London et al.: Bloomsbury Professional, 2012), 232.

¹⁶¹ In detail *Hambuechen*, above fn.135, 43 TC 90 (1964) at 99; *Rouse*, above fn.135, Tax Court Memo 1964-297, 23 TCM 1823 (1964).

¹⁶² *Commissioner v O.P.P. (O.P.P.)*, 76 F.2d 11 (12) (2d Cir. 1935); *Castle Harbour*, above fn.129, 459 F.3d 220 (2006) at 232.

capital must in addition be configured so as to be risk-free. The often-used test whether “the funds were advanced with reasonable expectations of repayment regardless of the success of the venture or were placed at the risk of the business”¹⁶³ points in this direction. This indicates that it depends above all on the security of the repayment. In its landmark judgment from 2006, the *Federal Court for the 3rd District* denied a foreign bank the recognition as *partner* in respect of its interest in a leasing business, because—due to the secure revenue of the business—its contractual share of profits had to be regarded as fixed repayments of interest and principal. At the same time it was stressed: “On different facts a difficult question would arise whether an investor’s right to a share in the profits was sufficient to make its interest a bona fide equity participation for tax purposes notwithstanding the secured guaranty of the return of its principal plus interest.”¹⁶⁴ Applying this, if even a guaranteed minimum rate of interest with an additional profit share does not necessarily prevent a classification as a *partnership*, then the same must be true of a simple share of profits.

If and to the extent that a capital investor is allocated a share in losses alongside his share in profits, two situations must be distinguished: losses either lead simply to a waiver of future profit shares—until the losses have been offset, or the losses result in a real reduction of the claim to repayment of the capital granted. It is only in the latter circumstance that one can speak of a true participation in losses.

The tax consequences are viewed differently in the examined countries. In France, a participation in losses always leads to the classification of the legal relationship as a silent partnership and thus to the realm of equity for tax purposes if the capital investor enjoys co-determination rights at least in the sense of control rights.¹⁶⁵ Indeed, in France limited liability partners—partners with limited liability and silent partners—are treated like shareholders, thus the share of profits is not “directly attributed” to them but is instead taxed at the level of the partnership and is only caught at the level of the partners when dividends are distributed.¹⁶⁶ In contrast, German and Austrian¹⁶⁷ law includes a silent partnership in principle within the realm of partner taxation, and indeed requires from an “atypical silent partner”, as for a shareholder, a participation in the “hidden reserves” in the event of a liquidation or a resignation from the partnership in return for compensation (or particularly well-developed co-administrative rights).¹⁶⁸ Swiss law allows (in contrast to all other examined legal systems) a participation in losses for participating loans as well, which does not change anything with respect to the private law and

¹⁶³ *Gilbert v CIR (Gilbert)*, 248 F.2d 399, 402 (2nd Cir. 1957), 406.

¹⁶⁴ *O.P.P.*, above fn.162, 76 F.2d 11 (12) (2d Cir. 1935); *Castle Harbour*, above fn.129, 459 F.3d 220 (2006) at 232.

¹⁶⁵ See administrative instruction BOFiP-Impôts BOI-BIC-CHAMP-70-20-60-20120912, above fn.149, para.50, and Conseil d’Etat, 18 mars 1970, No.77618, available at: <http://www.easydroit.fr/jurisprudence/Conseil-d-Etat-7-9-SSR-du-18-mars-1970-77618-publie-au-recueil-Lebon-77618/J7476/> [Accessed April 7, 2014].

¹⁶⁶ Code Général des Impôts Art.206(4).

¹⁶⁷ See, for example, VwGH November 24, 2004, 2000/13/0107; December 22, 2004, 2004/15/0126; April 21, 2005, 2000/15/0058; February 27, 2008, 2005/13/0050.

¹⁶⁸ *Haep*, above fn.152.

tax law classification as a simple credit relationship.¹⁶⁹ The “silent partnership” as an undisclosed partnership with profit and loss participation is here¹⁷⁰ by way of contrast seen just as little in practice as in the UK.¹⁷¹ According to the criteria in US law, a true participation in losses by a capital investor is a significant indicator of the existence of a *partnership* or a *joint venture* for tax purposes.¹⁷²

An atypical risk of default for the investor of capital can arise—even when there is no contractual participation in losses—if the usual security is waived, if agreement is reached for the right to repayment to rank lower than the claims of other business creditors or simply due to the debtor’s actual lack of solvency at the time the capital is committed. US law considers all of these situations to be possible but not absolute indicia of equity, because a business risk is manifested in them, which a typical creditor would not take on.¹⁷³ Even lower-ranking business loans have as a rule been classified for tax purposes as real *loans*.

All other legal systems consider the criterion of rank to be largely irrelevant¹⁷⁴: if and to the extent that the commitment of capital occurs contractually in return for a fixed repayment and fixed interest, even significant additional risks do not establish a partnership or company nor any other form of joint business undertaking from a tax point a view.

It is only under German and Austrian law that the participation in latent gains by an investor of capital is of critical significance for the classification of a taxpayer as a “business partner”.¹⁷⁵ However, one has to be clear here that this concerns a requirement shaped by the specific distinction between business income and private income, which above all is designed to ensure that capital gains on the disposal of these interests are caught. It appears noteworthy that, according to this criterion, even a regular limited partner can lose his position as an equity investor and be treated like a creditor if he has only a fixed right to repayment of his investment. The other legal systems simply pay no heed to the participation in latent gains. Only in the US is such an increased participation in the opportunities and risks of the business—as part of the *multi-factor test*—considered to be an additional indicator.¹⁷⁶

¹⁶⁹ Bundesgericht, above fn.100, BGE 99 II 303, 306 and following, Erwägung 4c) 3 and Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.a; B. Broda, “Mezzanine Finance—Finanzierungslücken flexibel schliessen” (2003) 77 *Der Schweizer Treuhänder* 977, 978; H. Baumgartner, “Mezzanine Finanzierungen für KMU im Aufbruch—Schliessen von Finanzierungslücken bei Unternehmensnachfolge und in kritischen Wachstumsphasen” (2006) 80 *Der Schweizer Treuhänder* 560, 561.

¹⁷⁰ Meier-Hayoz and Forstmoser, above fn.47, §15 No.55 and following.

¹⁷¹ This is, inter alia, due to the fact that “dormant” or “silent” partners incur unlimited liability under English law, cf. Banks, above fn.19, 93, 438.

¹⁷² *Hunt v CIR (Hunt)*, T.C. Memo 1990-248 (1990); *O’Hare v CIR (O’Hare)*, 641 F.2d 83, 86 (1981); R.H. Scarborough, “Partnerships as an Alternative to Secured Loans” (2005) 58 *Tax Lawyer* 509, 529 and following.

¹⁷³ *US v Title Guarantee & Trust Co*, 133 F.2d 990 (1943); *O.P.P.*, above fn.162, 76 F.2d 11 (12) (2d Cir. 1935) at 12 and following; *Roth Steel Tube Co v CIR (Roth Steel)*, 800 F.2d 625 (1986); *Fin Hay Realty Co v US (Fin Hay)*, 398 F.2d 694 (1968) at 696 and following; B.I. Bittker and J.S.Eustice, *Federal Income Taxation of Corporations and Shareholders*, 7th edn (New York: Valhalla, 2005), 4.03 [2] [d], [e] and [g].

¹⁷⁴ See as an example from French law Code monétaire et financier Art.L.313-13 para.2 and Raimbourg and Boizard, above fn.61, para.26.111, regarding the treatment of lower ranking participating loans (*prêts participatifs*); for the UK cf. J. Tiley, “National report ‘UK’ in M. Geerten (ed), *Tax Treatment of Financial Instruments—A Survey to France, Germany, The Netherlands and the UK* (The Hague: Kluwer, 1996), 263, 309.

¹⁷⁵ Haep, above fn.152, note 394.

¹⁷⁶ Compare W.T. Plumb, “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal” (1971) 26 *Tax Law Review* 369, 526 and following.

The statutory or contractual granting of administrative rights to capital investors can also be consulted from a tax point of view to examine whether a “business partner-like” relationship exists. It can also play a role in the question of whether the relationship is one of a loan or a partnership/company for private law purposes. French law takes business management rights or the requirement to seek the approval of the investor of capital—assuming a participation in losses—as a reason to assume a *société*, which leads to the application of semi-transparent taxation to the revenue of the partners (or its subjection to corporate tax).¹⁷⁷ German and Austrian¹⁷⁸ law examine these circumstances primarily with the question: do they give rise to a tax “partnership relationship”?¹⁷⁹ US law ultimately includes both the *participation in management by the holder of the instrument* as well as the *voting power of the holder of the instrument* as indicia for the classification of capital as equity—although not with the same intensity that it accords to full participation in the assets of the enterprise.¹⁸⁰ However, in practice it continues to be recognised that the detailed *covenants* of US-specific corporate bonds, which carry comprehensive procedural obligations for the business as well as control rights for the investor and the requirement to seek the approval of the investor (banks or capital market investors), do not justify the classification of these loans as equity.

All legal systems ultimately agree that the simple existence of creditor information rights—on a statutory or contractual basis—does not suffice to classify a capital investor as a shareholder or partner.¹⁸¹

It has already been indicated that a few legal systems within the group where partners are jointly taxed distinguish between those persons who participate actively in the business and those persons who consider their engagement to be a simple capital investment. Both British¹⁸² and US law, and to a certain extent French law¹⁸³ as well, require a quantitatively significant active involvement of the capital investor in the business before losses from “commercial” activities may be offset against positive revenue from another source. This demonstrates that the simple membership of a commercial partnership/company may not be equated with personal—time-consuming—involvement in the form of work in such a partnership/company. Primarily it demonstrates that the group of “partners/shareholders” in a wider sense and the group of “business partners” in a narrower sense do not have to be identical in so far as the additional legal consequences are concerned, but instead can form concentric circles.

¹⁷⁷ Administrative instruction BOFiP-Impôts BOI-BIC-CHAMP-70-20-60-20120912, above fn.149, para.50.

¹⁷⁸ For details refer to E. Lechner, *Die Gewinnpoolung im Ertragsteuerrecht* (Köln: Deubner, 1986), 250 and following.

¹⁷⁹ See for Germany Haep, above fn.152, §15 note 309 and following.

¹⁸⁰ *TIFD III-E INC. v US*, 660 F.Supp.2d 367, 389 (2009); *Hunt*, above fn.172, T.C. Memo 1990-248 (1990) at 53; *O’Hare*, above fn.172, 641 F.2d 83 (1981) at 87; J.W. Dantzer, “Debt vs. Equity in the Partnership Context” (2006) 110 *Tax Notes* 497, 503, 507; Scarborough, above fn.172, 529 and following.

¹⁸¹ For France see for example C. Osterloh-Konrad and N. Lagdali, “Eigen- und Fremdkapital im Steuer- und Gesellschaftsrecht Frankreichs” in Schön, above fn.14, 373, 392.

¹⁸² ITA s.110 and following.

¹⁸³ See Code Général des Impôts Art.156(I)(1) bis as well as, regarding the line of demarcation, Osterloh-Konrad and Lagdali, above fn.181, 407.

A new approach to debt and equity in income tax law

The starting point for a new definition must, against the background of the above analysis of the situation, be that in most legal systems the classification of a capital stake as equity or debt is connected with several different legal consequences: the collective assessment and direct attribution of revenue, the classification of the engagement as “entrepreneurial”, the application of rules about the assessment of revenue from business operations (as a rule the accruals method), certain varieties of taxation of capital gains as well as (depending on the respective legislation) specific benefits and charges for commercial activities. This leads firstly to the question whether it appears to make sense to link all of these legal consequences to the same distinction. A good example is the situation under German law. Here, the classification of a person involved as a “business partner” is critical not only for his or her material inclusion within §15 paragraph 1 section 1 No.2 EStG (Einkommensteuergesetz—Income Tax Law), which results in the application of the procedural technique for the so-called “uniform and separate determination of profit”, to profit being determined according to the accruals method and a share of the profit being directly allocated to the taxpayers; it is also critical for the application of specific trade tax burdens (including the legal notions of “special business assets” owned by individual partners and “special remuneration” paid to partners for services rendered to the partnership) and to the taxation of capital gains in accordance with §16 paragraph 1 No.2 EStG.

Until now, the question of whether it makes any sense to link all named legal consequences to the same factual circumstances was not discussed in German tax law. A look at other legal systems shows, however, that it is indeed possible to provide for a uniform profit assessment and profit allocation for a widely conceived circle of “partners/shareholders” and to make certain additional legal consequences dependent on the existence of specific “entrepreneurial” qualities of these persons. Thus, in the following section, the factual circumstances will be closely linked to the concrete legal consequences.

As a first step it is useful to pose the question: which factual features of an investment of capital should tip the balance towards the application of the rules regarding the uniform assessment and direct allocation of profit?

A decisive pre-requisite for both of these legal consequences is that several persons generate joint profits. Therefore, a profit figure must be generated on the basis of joint contributions (work and/or capital), which can be distributed across the persons involved in accordance with the underlying agreements and complementary private law norms. This excludes, first, those capital investments that are directed towards a fixed rate of interest. The same must be true of capital investments that are linked to variable indices without being directly connected to the profit of the business, for example, where the remuneration is dependent on turnover or an index. In these cases, there is no real reason for a uniform profit assessment and direct allocation of profit to be imposed.

This leads to the further question whether all legal relationships that involve a participation in business profits must lead to the uniform assessment and direct allocation of profits. Here, contractual relationships that are not based in a strict sense on a contribution of capital should be excluded, for example, employment contracts (“bonus payments”) or with profit participation rental contracts. These are typically subject to their own income tax rules on the basis of the

characteristic “main object” of the arrangement (for example, for salaries the “pay as you earn” tax rules apply).

The demarcation between equity and debt therefore only plays a role when a capital investor makes a financial contribution through the investment of funds and is granted a share in profits in return.

If one further narrows the field of capital contributions in return for a participation in profits, one must pose the question whether a line should be drawn between a participation in profits based on joint ownership of commercial assets (like a fully-fledged partnership) and a participation in profits on the basis of an “undisclosed relationship” (like a silent partnership or a profit-dependent loan). Should these contractual instruments also be subject to a joint profit assessment and direct allocation of profits? This requires a differentiating analysis:

1. For profit participations based on joint ownership (for example, asset-holding partnerships) the need to include all persons participating in the profits arises as a result of the tax objective to capture all profits accruing in a business for tax purposes in the hands of the part-owners before they are withdrawn by the taxpayers involved or by other means. If the association is itself the holder of the commercial assets, but is on the other hand not itself subject to income tax law or corporate tax law (like a partnership), then there is an urgent need for the profits to be exhaustively captured and directly attributed to the persons entitled to a profit share. Otherwise, a “tax gap” would arise for the retained profits of partnerships.
2. However, for these purposes it is neither required nor useful to restrict the circle of affected partners/shareholders to those persons who, through their involvement in the business or the assumption of specific risks and chances, appear to be active “business partners”. These features are without significance in so far as the exhaustive and direct taxation of business profits is concerned.
3. For “profit communities based” on contractual rights (for example, silent partnerships or profit-dependent loans), the regulatory technique discussed here of a joint profit assessment and direct allocation of profits is not as imperative as it is for fully-fledged joint ownership of assets. A “tax loophole” can be avoided in this instance if the generated profit is allocated firstly to the owner of the business and this taxpayer may only claim a deduction for the profit shares payable to the capital investors at the point in time that the capital investors receive this income. This requires a linkage between the income measurement methods used by the capital investor and by the recipient of the capital (in the sense of a “corresponding accounting”). The existence of a “tax gap” can be avoided if the capital investor and the recipient of the capital conduct a “corresponding profit assessment” for each profit participation.
4. Against this background one can simply ask the question whether there are reasons of practicability that can be invoked for a joint profit assessment and direct allocation of profits for contractual profit participations. From a procedural point of view it can be said that such a joint assessment would support an exhaustive and non-redundant determination of the overall profit as well as a clear and consensual distribution of the aggregate for all those involved. Moreover, the

inclusion of contractual profit participations can ensure that the choice for taxpayers between a profit participation based on joint ownership of business assets and one based on contractual rights is not tax-driven. This technique of joint assessment can also be implemented in case the total business profit serves as the starting point for further tax consequences (for example, for the uniform taxation of the commercial earnings of the business under a trade tax). This is, however, ultimately a question of practical expediency and not one of logical validity.

5. If, however, simple contractual profit participations do not necessarily belong to the circle of financial instruments which are subject to a joint profit assessment and direct profit attribution, then it must be considered in a further step whether certain features can alter the picture. In most states—as mentioned—a simple participation in profits is not considered to be a sufficient reason for the classification of a capital share as “equity”. Other critical features include, for example, the classification of a financial instrument as a partnership in contrast to a simple participating loan; moreover, a participation in losses or an agreement to share in the latent gains of the enterprise can make a difference. If one looks more closely, there are also inter-relationships between these features in some legal systems—under French law the participation in the losses of an enterprise is the authoritative marker of the borderline between a silent partnership and a participating loan under partnership law versus contract law.¹⁸⁴
 - (a) This means, first, that the tax consequences cannot be closely tied to the private law classification of a legal relationship as a “partnership” or “company” in accordance with the relevant national law. Instead, the substantive financial features of the participation right must be decisive.
 - (b) If one considers the practice in the examined legal systems, the emphasis placed by Germany and Austria¹⁸⁵ on the participation in the hidden reserves (that is, an atypical silent partnership) continues to stand out as an anomaly. This feature owes its great significance in these legal systems to the fact that profits on a disposal of such a participation should be caught for tax purposes. This can only succeed (according to the traditional legal position of the restricted taxation of capital gains) if the capital participation is classified as a commercial engagement. In other states such profits on disposal are simply caught by the general capital gains taxation, so that a comparable discussion has not even developed.¹⁸⁶ It should therefore be without relevance for the question raised above regarding the uniform assessment and direct attribution of profits.
 - (c) The same applies to a contractual clause that the capital investor will participate in the losses of the enterprise. It is correct that the collective

¹⁸⁴ Merle, above fn.23, para.714.

¹⁸⁵ See, for instance, VwGH February 23, 1994, 93/15/0163; June 29, 1995, 94/15/0103; April 21, 2005, 2000/15/0058; February 27, 2008, 2005/13/0050.

¹⁸⁶ For the UK cf. K. Walton, *Tolley's Capital Gains Tax 2013-14* (London: LexisNexis Butterworths et al., 2013), para.48.1 and following.

assessment and direct attribution of profits to several persons applies, as a rule, to collective losses as well. To this extent, the participation in losses increases the practical application of this regulatory system. It also allows the trouble-free assignment of the relevant share of losses to the capital investor as part of his personal income taxation in a timely fashion.

(d) Ultimately it must be noted that in France¹⁸⁷ and Greece¹⁸⁸ even the investments made by “silent partners” are classified as equity, albeit not in income tax law but rather as part of a self-standing corporate tax liability for silent partnerships. This has the result that limited liability partners cannot set off partnership losses directly against positive income. Whereas if one decides not to extend the circle of entities subject to corporate tax in this way, mere contractual profit participations can essentially be classified as debt of the relevant enterprise.

6. If—under income tax law—one places emphasis on the “communality” of the generation of profit, then it cannot ultimately depend on the subordination of contractual entitlements or the risk of insolvency born by receivables. These features do not address the existence of a “profit community” in the relationship between the capital investor and the recipient of the capital, but rather simply affect the risk of a default in payment by the recipient of the capital or the ranking of the capital investor compared with other creditors of the same contractual partner in the event of his insolvency. Both elements are outside the teleology of the taxation of jointly generated profits.

In recognition of the fact that the tax law characteristics of any collective generation of profits must determine the classification of the relevant underlying capital participation, a further question must be discussed, namely whether a certain capital participation, considered separately, exhibits a commercial character. A study of the examined legal systems shows that the “commercial character” of a participation can itself bring preferences and disadvantages with it. In some legal systems, only “entrepreneurial” partners are able to set off losses against positive income from other sources.¹⁸⁹ The same applies to the profit-reducing write-down of a share in a partnership, which, for example, is allowed under French law for operationally-involved partners,¹⁹⁰ whereas under German law (in addition to the direct allocation of a share of losses due to the position as a partner) it is not recognised at all. To test these independent entrepreneurial commitments the following qualifiers can play a role, for example, the professional activity of a partner/shareholder, the extent and the actual use of his participation rights, the breadth of assumption of risk.

In any case it should be noted that this topic ultimately sits at “diagonals” to the previously depicted difficulty of the collective assessment and direct attribution of profit. In other words: the “commercial” or “entrepreneurial” character of a capital participation from the point of view of the capital investor has a priori nothing to do with the classification of his investment as

¹⁸⁷ Code Général des Impôts Art.206(4).

¹⁸⁸ KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Art.10(1).

¹⁸⁹ e.g. in France, see Code Général des Impôts Art.156(1)(1) bis.

¹⁹⁰ As a result of the fact that the share is recorded as a separate economic good among the operating assets, see Code Général des Impôts Art.151 nonies.

“equity” of an enterprise and therefore nothing to do with the tax consequence of a collective assessment and direct allocation of profits.¹⁹¹

The question of the commercial character of a capital investor’s individual share should, on the other hand, not be mixed up with the question of the scope of special charges for commercial enterprises. Thus, it can be argued with good reasons that the trade tax, as a tax on a commercial enterprise itself, seen as an “object”, should capture all sources of finance of an enterprise and the resulting earnings shares. This is not based, however, on the commerciality of the contribution nor of each individual financier in person, but rather is achieved by adding the appropriate return on capital to the commercial earnings. Thus, according to the original legal situation in the Trade Tax Act 1936, all profit shares of silent partners (regardless of whether they were “typical” or “atypical”) were added to the commercial return of the enterprise. The same applied to long-term loans (independent of the character of the returns as fixed interest or variable profit-share). Because the German legislature has considerably reduced the inclusion of capital returns in the base of the trade tax in the last few decades for loans as well as for typical silent partnerships, the significance of, for example, the borderline between typical and atypical silent partnerships has clearly risen. This cannot be explained by the character of the trade tax as an objective tax on commercial operations.

The circle of equity investors must be tightly drawn in income taxation. Essentially, the only people who belong within this circle are those who, on a partnership law foundation, have established joint ownership as the holders of a commercial enterprise. In order to ensure that the retained profits of this asset community do not remain temporarily untaxed, the annual profits or losses should be jointly assessed and an appropriate share allocated directly to the parties involved.

Whether, in addition to this, contract-based profit participations should also be subject to such a collective assessment of income and direct allocation of profits is a question of tax practical expediency, for example, so that the choice between joint ownership and a contractual profit participation is not tax-driven. In any case, a possible “tax gap” can be closed by requiring the capital investor and the recipient of the capital to undertake a revenue assessment that materially corresponds. Furthermore, it must be ensured that the profits from the disposal of capital participations are subject to a consistent tax treatment regardless of the character of the participations.

In so far as individual state tax systems link legal consequences to the “entrepreneurial” or “commercial” character of the participation itself, they are free to set typological features for this within the framework of the partner/shareholder’s involvement and bearing of risk.

Ultimately, the fundamental idea of financial neutrality in trade tax law can be accommodated by a broadly drawn concept of inclusions for the return on capital—be it debt or equity—under the relevant tax statute.

¹⁹¹ See most recently the considerations of Seer to allocate a “commercial character” to the position of the members of a corporation who manage the business, R. Seer, “Der unternehmerische Kapitalgesellschafter” in W. Schön and C. Osterloh-Konrad (eds), *Kernfragen des Unternehmenssteuerrechts* (Berlin: Springer, 2010), 97 and following.

The classification of capital in corporate tax law

The principal tax consequences of the classification of capital

Corporate tax law is marked by the general starting point that certain, legislatively-defined, pools of assets or bodies of persons are subject to personal tax liability for the income generated by them. This type of tax is not self-evident and does not in any way result from the private law legal capacity of a legal entity as such. From the point of view of the general concept of income, it would be conceivable for the shareholders to be exclusively subject to tax in respect of the profits generated within an entity. This could occur either through a direct allocation of the shares of profit and loss (as for partnerships) or through a continuous capture of the changes in value of the shares in the company as well as the dividends flowing to the shareholders.¹⁹² For practical reasons, tax law does not want to ask this of companies and shareholders—above all this is hard to conceive of for large corporations.¹⁹³ However, the taxation of these profits should not wait until the revenue generated in these entities is received by the shareholders as dividends or as capital gains. This would only make sense in the context of the introduction of a consumption tax, which no tax state has, up until now, comprehensively and permanently enacted.¹⁹⁴

Against this background, corporate taxation proves itself to be necessary in order to capture the retained income of certain commercial associations in a targeted way.¹⁹⁵

This objective requires a two-fold decision from the legislature: as a first step it must be determined which entities should be subject to corporate tax. As a second step, it must be clarified which components of the results generated in the enterprise should count as profits of the enterprise and to what extent capital returns can reduce the profits of the entity. If and to the extent that these returns do not reduce the profit of the entity, then the further question arises, if and in what way are they subject to further taxation on distribution to the recipients—typically via income tax—or whether relief mechanisms should be built in at the level of the recipient.

Many divergent answers can be found in the examined jurisdictions to the question which entities should be taken out of the scope of individual income tax law and moved to the scope of corporate income tax law (particularly the circle of *semi-transparent* taxed partnerships). Traditionally, the large capital markets-oriented companies limited by shares are among the enterprises that are subject to corporate tax in all states.¹⁹⁶ As a rule, they are joined by closed corporations of various types, for example, unlisted companies limited by shares and the German GmbH (*limited liability companies*) as well as their equivalents in other legal systems.¹⁹⁷ However, in the last few decades the tendency has become stronger and stronger to grant at least the last-mentioned category of companies a right to opt for the classification as a transparently taxed

¹⁹² Schön, above fn.128, 142 and following. See also Harris, above fn.16, 170 and following.

¹⁹³ US Treasury Department, *Report on integration of the individual and corporate tax systems, Taxing Business Income Once* (1992), Ch.3, 27 and following; Knobbe-Keuk, *Bilanz- und Unternehmenssteuerrecht*, 9th edn (Cologne: Schmidt, 1993), §14 III.

¹⁹⁴ But see the criticism regarding the continued existence of corporate tax in Gordon, above fn.125, 407 and following.

¹⁹⁵ *The Mirrlees Review*, above fn.6, 408 and following; Harris, above fn.16, 145, 170 and following.

¹⁹⁶ H. Ault and B. Arnold, *Comparative Income Taxation*, 3rd edn (Alphen aan den Rijn: Kluwer, 2010), 339 and following.

¹⁹⁷ For the legal situation in Germany see KStG (Körperschaftsteuergesetz—Corporate Tax Act) §1 para.1.

partnership/association.¹⁹⁸ On the flip-side, it cannot be said of partnerships that their profits will, without exception, be captured in income tax law on the basis of transparent taxation. In some countries, partnerships in general or in any case certain commercial partnerships with legal capacity are included within the circle of corporate tax subjects¹⁹⁹; other jurisdictions provide (certain) partnerships with the option of being subject to corporate tax.²⁰⁰ In extreme cases, even sole proprietors can come under the scope of corporate tax law.²⁰¹

The decision to include certain associations of individuals or pools of assets within the area of application of corporate tax does not yet appear to directly compel a differentiation between equity and debt in order to assess their profit. For these entities, the legislature could decide either to allow a deduction for all capital returns as business expenses or to prevent any deductions for capital returns as business expenses without the need for any further differentiation. The same applies to the often-discussed legislative proposal to allow a fixed percentage of the total capital in each case—regardless of the origin of the funds—to be tax-free each year (*allowance for corporate capital*) and to prevent a deduction as business expenses for any further payments to the capital investor.²⁰²

In practice, most states have decided not to allow a tax deduction for profit shares falling to equity investors. This is therefore perceived to be the fundamental divide between equity and debt finance. This solution appears to be a systematic imperative for retained profits, because a tax deduction for retained profits would prevent a timely corporate taxation of this component of income, which cannot be taxed simultaneously at the level of the shareholder either. Otherwise corporate tax would ultimately be a “zero tax” which—similar to the taxation of retained earnings of investment funds—would have to be supplemented with the auxiliary construct of deemed distributions.

In contrast, a deduction as business expenses was by all means the practice for distributed profits in some earlier corporate tax systems²⁰³—most recently in Greece until 1992 within the framework of the “Dividend Deduction Method.”²⁰⁴ More recently Reuven Avi-Yonah has brought this method back to life as an option for tax policy.²⁰⁵ The dividend deduction method has the advantage that it elegantly solves the problem of economic double taxation of corporate revenue; the dividends are subject to income tax at the same time as they are deducted by the corporation so that, on the one hand, no “tax gap” arises and, on the other hand, double taxation is avoided.

If one asks why the deductibility of retained as well as distributed profit-shares is presently fundamentally denied by the corporate tax laws of the world, then for the usual case of a domestic

¹⁹⁸ Schön, above fn.128, 142 and following.

¹⁹⁹ Regarding new discussions in the U.S. see B.T. Borden, “Three Cheers for Passthrough Taxation” (2011) 131 *Tax Notes* 1353 and following. See also Harris, above fn.16, 24 and following.

²⁰⁰ For France see Code Général des Impôts Art.206(3).

²⁰¹ See in this regard Law No.4506/64 (DOU November 30, 1964) Art.41 §1 b in conjunction with Decree No.3000/99—DOU March 29, 1999; DOU June 17, 1999 Art.150 §1 II.

²⁰² R. Boadway and N. Bruce, “A general proposition on the design of a neutral business tax” (1984) 24 *Journal of Public Economics* 231 and following; E.D. Kleinbard, *Rehabilitating the Business Income Tax*, The Hamilton Project (Washington: 2007).

²⁰³ P.A. Harris, *Corporate/Shareholder Income Taxation* (Amsterdam: IBFD, 1996), 61 and following.

²⁰⁴ KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Arts 24, 99, 106.

²⁰⁵ R.S. Avi-Yonah and A.C. Chenchinski, *The Case for Dividend Deduction* (Michigan Law, 2010), Empirical Legal Studies Center, Working Paper No.10-028.

corporation with domestic shareholders, practical and political arguments are to be seen rather than systematic imperatives:

1. Corporate tax is often, on the basis of earlier theories, understood to be not simply a pre-payment of the tax payable by the shareholders but rather as the uptake of the corporation's "own tax-paying capacity."²⁰⁶ This does not depend on the use of the profit. However, this theory lacks an economic base: a corporation is ultimately only a contractual instrument for the shareholders to achieve a limitation of liability and a co-ordination of resources.²⁰⁷ This cannot be reconciled with a profit-related "special tax" for corporations, at best a limited *franchise tax* for the availability of the legal form and its institutional protection by a jurisdiction.²⁰⁸
2. In recent US literature, corporate tax continues to be understood as a measure for the regulation of large public corporations, namely the mastery of the economic and political power of the management.²⁰⁹ However, in terms of the non-deductibility of profit distributions, nothing results from this—rather the opposite is true. Because with the distribution of business assets to the shareholders the management foregoes its control over these resources and thereby consciously reduces its own (and also self-serving) managerial leeway. To this extent, the dividend deduction method can be a disincentive for "*empire building*" within the enterprise.
3. In many states, the sizeable revenue from the corporate tax naturally takes priority from a practical fiscal point of view, and this amount could not be levied to a comparable extent with comparable simplicity through an individual taxation of dividends in the hands of the shareholders.²¹⁰ In addition, a substantial waiver of a tax on corporations would in many cases not be politically achievable. Nonetheless, this does not constitute a compelling statement against the dividend deduction model.
4. A point which has not been addressed in the previous debate is the following: the dividend deduction method provides the taxpayers (corporation and shareholders) with extensive freedom regarding the question of when positive results are recorded at the level of the corporation and when they are recorded at the level of the shareholder. By deciding on the timing of distributions the company and its shareholders are able to configure the tax burden to a large extent both with regard to the timely application of tax progression (for the shareholder) as well as with regard to the availability of losses that can be set-off either at the level of the corporation or at the level of the shareholder. This very ability to configure the burden contradicts the basic assumption of both income tax law as well as corporate

²⁰⁶ Still the justification for the KStG (Körperschaftsteuergesetz—Corporate Tax Act) 1920 (evidence in Knobbe-Keuk, above fn.193, §14 I).

²⁰⁷ A.C. Warren, "The Corporate Interest Deduction: A Policy Evaluation" (1974) 83 *Yale Law Journal* 1585, 1600 and following; *The Mirrlees Review*, above fn.6, 408 and following.

²⁰⁸ Regarding the "franchise tax" in the US/Europe relationship see W. Schön, "Playing Different Games" (2005) 42 *Common Market Law Review* 331.

²⁰⁹ R.S. Avi-Yonah, "Corporations, Society and the State: A Defense of the Corporate Tax" (2004) 90 *Virginia Law Review* 1193.

²¹⁰ Institute for Fiscal Studies, *Equity for companies: a corporation tax for the 1990s* (London: 1991), note 1.2.6.

tax law, that the relevant taxpayer should not be able to alter the extent of his annual tax liability by shifting income to other persons and in doing so at the same time circumvent the application of the rules regarding the synthetic concept of income. If and as long as one holds true to the fundamental principle of a synthetic individual-related taxation of income, the dividend deduction method is problematic.

A further key argument against the dividend deduction method is to be seen in the cross-border situation: for domestic investments by foreign investors, the deduction of dividends leads to an undermining of the function of corporate tax as a withholding tax for business revenue removed from the territory. This would have to be compensated for by a comprehensive capital yields tax (against the trend of reducing the withholding tax rates in international treaty law). From the point of view of European law, this would involve a breach of the provisions of the Parent-Subsidiary Directive for inter-company holdings.²¹¹ This legitimises the current general practice of taxing corporate profits without regard to their distribution or retention. On the other hand, this leads to the differentiation of returns on debt at the level of the corporation for which (in most legal systems) the usual deduction for operating expenses is available. It does not appear to make sense to limit such a rule to those dividends flowing to foreign countries only—on the one hand this would be discrimination, on the other hand it would be very difficult to draw the border-line, especially for public companies. The lack of practicability of the dividend deduction method for dividends flowing to foreign countries thus prevents its overall usefulness as a part of corporate tax law.

With the decision that (paid out or retained) returns on equity are not deductible, a differentiation between returns on equity and returns on debt at the level of the corporation is automatically pre-programmed.

This gives rise to a difficulty for the tax treatment of the capital investor that one can describe as a legislative choice between a legal and an economic “equal treatment” of equity and debt. If the legislature decides to apply the same income tax law rules to returns on equity and returns on debt for the taxation of the capital investor, then a legal differentiation between these types of capital is not required, but at the same time the tax effect will perpetuate the non-equal treatment of debt and equity applied at the level of the corporation. This is true irrespective of whether one makes paid-out dividends and interest simply subject to regular income tax rates, whether one—as is presently the case in Germany²¹²—levies a uniform withholding tax on both types of capital earnings, or whether one waives taxation of the capital returns to the investor in whole or in part regardless of the type of capital earnings. This “*debt bias*” has been criticised for a long time as a damaging distortion of financing decisions.²¹³ Thus, in a “classic” corporate tax

²¹¹ *Athinaiki Zythopoiia AE v Greece* (C-294/99) [2001] ECR I-6797.

²¹² S. Eberl, “Weitere Erkenntnisse zum Steuervorteil von Fremdkapital nach der Unternehmenssteuerreform 2008” (2009) 61 *Zeitschrift für betriebswirtschaftliche Forschung* 251.

²¹³ Fundamentally: M.H. Miller, “Debt and Taxes” (1977) 32 *Journal of Finance* 261; J.K. MacKie-Mason, “Do Taxes Affect Corporate Financing Decisions?” (1990) 45 *Journal of Finance* 1471; J.R. Graham, “How Big are the Tax Benefits of Debt?” (2000) 55 *Journal of Finance* 1901; R.H. Gordon and Y. Lee, “Do taxes affect corporate debt policy? Evidence from US corporate tax return data” (2001) 82 *Journal of Public Economics* 195; R.H. Gordon, “Taxation and Corporate Use of Debt: Implications for Tax Policy” (2010) 63 *National Tax Journal* 151. See also Harris, above fn.16, 181 and following, 243 and following.

system, which accepts a double taxation of equity earnings, one would tend to be critical of the deductibility of interest on loans to further equal treatment of debt and equity.²¹⁴

On the basis that the currently practised tax systems make the receipt of interest subject to income tax (depending on the jurisdiction, at the normal tax rate or a lower rate) the legislature therefore has the choice either to treat dividends legally analogously—then there will be an economic double taxation of profits generated in the corporation—or to look for ways to recognise the prior taxation of dividends at the income tax law level. Most states have decided to go down the latter path and have prescribed a full exemption from taxation (Brazil,²¹⁵ Greece²¹⁶), a proportionate exemption from taxation (Germany (for business holdings),²¹⁷ France,²¹⁸ Switzerland²¹⁹), a reduced tax rate (Germany (for private holdings), Austria, UK,²²⁰ US) or an imputation of the prior corporate taxation (as is still the case in Australia and New Zealand). These relief techniques make it necessary to once again pick up the prior corporate law differentiation between equity and debt at the income tax level. The same applies to the payment of *intercompany dividends*, which in many countries (at least above a certain minimum size of holdings) are completely or to a great extent tax-free²²¹ and thus represent a contrast to *intercompany interest*, which as a rule (regardless of the existence of statutory limits on deductibility at the level of the paying entity) is taxed in the hands of the recipient.

Of greater significance for legislation and legal practice is the fact that even a corporate/shareholder taxation which is neutral as to the source of finance, and which captures the capital returns for tax purposes either at the level of the partnership/company (equity) or at the level of the partners/shareholders (debt), can bear some material tax consequences as regards the classification of the types of capital. This occurs when the corporation or capital investor itself has specific tax-relevant properties. The manifold personal tax exemptions for capital investors with respect to investment income (non-profit or public entities, pension funds, etc.) are an important example where a positive taxation of interest is removed whereas nothing is changed with regard to the prior corporate taxation of dividends.²²² The horizontal and vertical balancing of losses offers another example. There may be significant carried-forward losses at the level of the partnership/company: then dividends that are subject to tax in the hands of the company but are tax exempt or tax-preferred in the hands of the capital investor clearly provide a greater benefit in terms of the total tax burden than interest which is deductible at the level of the company but fully taxed in the hands of the capital investor. The opposite is the case if it is only the capital investor who has losses that can be set off. It is exactly these sets of circumstances

²¹⁴ Warren, above fn.207, 1603 and following.

²¹⁵ Law No.9249/95 (DOU December 27, 1995) Art.10.

²¹⁶ KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Arts 24, 99, 106.

²¹⁷ cf. EStG (Einkommensteuergesetz—German Income Tax Act) §3 No.40 letter d).

²¹⁸ Code Général des Impôts Art.158(3)(2).

²¹⁹ For qualifying private holdings see Bundesgesetz über die direkte Bundessteuer Art.20 para.1 bis, for qualifying business holdings see Bundesgesetz über die direkte Bundessteuer Art.18b.

²²⁰ ITA ss.8, 13.

²²¹ So, for example, in the UK, see CTA 2009 s.931A and following; see also Harris, above fn.16, 278 and following.

²²² R. Vann, “Trends in company/shareholder taxation: single or double taxation? General Report” (2003) 88a *Cahiers de droit fiscal international* 21, 34 and following.

that have given rise to the special British rules regarding *disguised interest*²²³ as well as the special rules in Australian law²²⁴ regarding the demarcation between *debt* and *equity*.

These consequences of the differentiation can also be seen in the disposal of capital investments. Whereas capital gains on debt interests are typically subject to regular taxation or withholding taxes (in so far as they are not completely exempt from tax in individual jurisdictions as private capital gains²²⁵), the disposal of equity investments frequently receives preferential treatment with consideration for their prior taxation, and indeed either through allowances in the basis of assessment or a reduction of the tax rate,²²⁶ for inter-corporate holdings often even through an (almost) complete tax exemption. But this often corresponds with a simultaneous disallowance of losses on disposal or liquidation, whereas losses in the value of debt holdings can have tax effects (as part of the general rules regarding individual income measurement). Against this background—to prevent circumvention—the losses in the value of shareholder loans are often equated from a tax perspective with losses in the underlying equity stakes.²²⁷

The legislative decision not to allow a deduction for returns on equity in corporate tax must necessarily be connected with a decision as to which capital investors are included within the circle of those affected.²²⁸ In this respect, one could assume that there is a “core section” of constituent shareholders for every tax-paying entity of each respective chosen legal form: for companies limited by shares this is the (ordinary) shareholders with voting rights and rights to share in profits, for limited liability companies/partnerships it is the regular shareholders/partners. In so far as individual countries also subject partnerships to corporate tax, the share of profits that falls to the core partners cannot be deductible. This follows all the way to corporate tax-paying sole director/sole shareholder companies, who cannot deduct withdrawals made from the business for private purposes.

From the point of view of national corporate tax law, the question follows which further capital investors beyond the circle of the “core shareholders/partners” should also be subject to dividend taxation, that is, the non-deductibility of dividends as part of the corporate tax liability of the company/partnership as well as (depending on the legal position) the preferential tax treatment of dividends in the hands of the shareholders. Here, the variety of “mezzanine” financial instruments must be considered. A decision must be reached as to which features of hybrid holdings should be determinative when it comes to equating hybrid legal positions with classic equity holdings.

In this respect it is first of all clear that it is difficult to uniformly define the factual demarcation between equity and debt for all associations of persons subject to corporate tax. Because on one side of the picture, there is a great deal of variation in the type and extent of the participation and property rights of the “core” equity holders, from a shareholder in a public corporation to a sole director/sole shareholder. This can have an effect on the question of whether the holder of certain “hybrid” legal holdings is so similar to a “core shareholder/partner” of an association of

²²³ CTA 2009 s.486A and following, s.521A and following.

²²⁴ R. Woellner et al., *Australian Taxation Law*, 2nd edn (Sydney: CCH Australia, 2011), Ch.22, 1240 and following.

²²⁵ So, for example, in the UK, in so far as no *debt on a security* is present, TCGA s.251(1), s.132.

²²⁶ TCGA Sch.7AC (substantial shareholdings exemption); TCGA s.169H and following (entrepreneurs’ relief).

²²⁷ See e.g. EStG (Einkommensteuergesetz—Income Tax Act) §15 para.4 ss.6–8; KStG (Körperschaftsteuergesetz—Corporate Tax Act) §8b para.3 ss.4–7.

²²⁸ Fundamentally: Warren, above fn.207, 1585 and following.

persons subject to corporate tax, that a subsumption of this capital holding within the corporate tax regime appears appropriate. On the other hand this is often contrasted with the general position of a creditor on the “debt” side, which is not dependent on the legal form of the recipient of the capital—the *loan relationship*.²²⁹ This finding gives rise to the question whether the criteria for the demarcation between equity and debt can vary with the legal form of the recipient of the capital.

Finally it should be noted that two different forms of “equity” can overlap for the hybrid holdings of capital investors in the business of a corporation: the holding in the corporation and the formation of a further form of association with the corporation.

A good example is the difficult demarcation in German law between a “participation right”, whose holder is equated with a shareholder in §8 paragraph 3 section 2 alt. 3 KStG (Körperschaftsteuergesetz—Corporate Tax Act), and an “atypical silent participation” whose existence, from the point of view of income tax law, establishes a business partnership between the corporation and the capital investor.²³⁰ In both cases a differentiation between equity and debt must be drawn for tax purposes—indeed with completely different tax consequences and thus ultimately with different factual pre-requisites as well. Whereas the “atypical silent partnership” creates an independent partnership between the silent partner and the corporation, the holder of a participation right is seen as a quasi-shareholder of the corporation itself for tax purposes.

That this form of differentiation and overlap can also play a role in foreign jurisdictions is demonstrated by an example from the US, the decision of the US Tax Court in the proceedings *S.M. Plumbing v Commissioner*²³¹:

Harry Rosenblum was involved in the construction and sale of real estate through his holdings of *preferred stock* in the company S.M. Plumbing: he was promised a repayment of his investment of US \$50,000 as well as a half share in further profits amounting to at least US \$40,000. When Harry Rosenblum was paid out a total of US \$90,000 in settlement of his claims, he considered this in-flow to be a repayment out of the capital of the company, which is not deductible for the corporation whereas for him it invokes the favourable rules regarding private *capital gains*. In contrast, the Tax Court held, “that Harry did not invest in S.M. itself but, rather, in a joint venture with S.M.” with the result that the payment was, in his hands, a pay-out of a commercial profit share as *ordinary income* and in the hands of S.M. was not a payment from capital, rather the profits of S.M. could be reduced by the amount of this payment.

The case makes it clear that there is also a rivalry between various types of equity—particularly those similar to a partner in a partnership and those similar to a shareholder in a company—and that tax systems must develop legitimate differentiations considering the respective tax consequences.

Above all in the US tax discussion,²³² the differentiation between equity and debt possesses another important implication. This affects the timing and the character of the realisation of

²²⁹ See for example CTA 2009, Pt 5, which sets out the provisions on the legal institution of the loan relationships in the UK. These rules only affect corporate tax subjects; from the point of view of a corporation as the recipient or investor of capital, the legal form of the creditor or debtor is, however, irrelevant. See also Harris, above fn.16, 237.

²³⁰ See BFH (*Bundesfinanzhof*—Federal Fiscal Court) BStBl (*Bundessteuerblatt*—Federal Tax Gazette) II 2008, 852. *Plumbing*, above fn.140, 55 T.C. 702 (1971).

²³² See in this regard inter alia H.J. Schlunk, “Little Boxes: Can Optimal Commodity Tax Methodology Save the Debt-Equity Distinction?” (2002) 80 *Texas Law Review* 859; J. Strnad, “Taxing New Financial Products: A Conceptual

earnings and profits and losses on disposal for various financial instruments. The problem can be sub-divided into two areas:

1. The problem of the realisation occurring at different points in time for the corporation and the capital investor: for shares it is clear that dividends may not be deducted at the level of the corporation, and for capital investors dividends are only taxed at the time of payment. A “tax gap” cannot arise. In contrast, for debts the debtor is typically able to deduct the capital returns before payment, namely once the liability to make the payment has been incurred, whereas the taxation of the capital investor is often dependent on the in-flow of funds or another appropriation. The resulting “gap” can be closed either at the level of the parties involved through a “corresponding assessment of income” or through a (provisional) non-deductibility of the payment for the enterprise.
2. The timing and characterisation of capital income and profits on disposal at the level of the partners/shareholders are often dependent on the classification of the underlying financial instruments (type and extent of capital gains taxation, etc.). This classification can, on the other hand, be manipulated by the use of “synthetic” financial products, for example, through the combination of an acquisition of shares with a put option or through other—in part significantly complicated—configurations. Against this background, it is often claimed, especially in the American discussion, that debt and equity are exchangeable and therefore that the underlying distinction is not effective.²³³ However, this discussion is focused in a particular way on the internal frictions of the American capital gains taxation, which are not at the forefront of consideration here. Rather, it must be remembered that the central question of the deductibility of payments on certain financial instruments in the relationship between capital investor and capital recipient is totally and completely independent of whether the holder of the financial instrument can neutralise or otherwise manipulate the economic result of this payment through derivative transactions. Therefore this article will not deal with derivative transactions.

Criteria for the debt/equity divide under corporate income taxation

In contrast to the income tax difficulties considered in the previous chapter, the primary concern in the area of application of corporate tax law is neither the question of the direct attribution of jointly generated profits nor the classification of this revenue as commercial income. The central legal issues are the question of the deductibility of returns on capital paid by the corporation, the application of the rules regarding tax relief for earnings on participations and the special provisions regarding capital gains and capital losses of equity shares in corporations. From a practical point of view, the concern is, above all, the classification of modern financial instruments,

Framework” (1993) 46 *Stanford Law Review* 569; A.C. Warren, “Financial Contract Innovation and Income Tax Policy” (1993) 107 *Harvard Law Review* 460.

²³³ See fn.232.

particularly hybrid bonds or hybrid shares in the corporation, which carry atypical financial entitlements and sometimes also atypical control and voting rights.

An interesting preliminary question is whether the criteria, which have been developed for the income tax law demarcation between a business partner on the one hand and a creditor on the other, correspond to the criteria used in each legal system for the corporate tax law demarcation between a shareholder and a bond creditor. Explicit statements in answer to this question can be found in Germany and the US:

1. In Germany the question is discussed in relation to the problem, how does a business partner-like participation as an “atypical silent partner” distinguish itself from a shareholder-like participation like a *jouissance right*. In this respect, the financial entitlements (profit share and a share in the latent gains) are interpreted in the same way in income tax law and corporate tax law, whereas the significance of control rights should play a lesser role in the classification as a share-like holding in a corporate entity than it does in the classification of an atypical silent holding as a quasi-partnership.²³⁴
2. For US tax law, the US Court of Appeals for the Second Circuit clearly explained in the *Castle Harbour* decision that the indicia for the drawing of the boundary between *partners* and *creditors* correspond to those employed in the relationship between *shareholders* and *creditors*.²³⁵ Hence, many cross-references can be found in US case law between the judgments in these two areas.
3. The situation under French law is quite different. Here the participation rights of the capital investor play a role in the income tax demarcation between debt and equity. In contrast, in corporate tax the existence of non-voting shares makes it clear that participation rights play no particular role in the classification of the capital.²³⁶
4. In the UK the “loan relationship” is also a purely corporate tax institution, which is only relevant for corporations as lenders or borrowers. Otherwise, at least in the UK, the demarcation tends not to be uniformly handled, because special rules also apply to determine whether capital returns on hybrid financial instruments for corporations are deductible.²³⁷

If German law, above all, applies independent and further criteria here, this has its foundation in the hypothesis that a “business partner” has to be comparable with the “sole proprietor” of a business unit. This, in turn, is bound together with the notion that the application of a uniform assessment and direct attribution of profits is tied to the classification of each individual involved as an “entrepreneurial” taxpayer. It has already been demonstrated above that this equivalence is not necessary. In income tax law one can also accept (for partnerships) “second-class” partners

²³⁴ See e.g. BFH (*Bundesfinanzhof*—Federal Fiscal Court) BStBl (*Bundessteuerblatt*—Federal Tax Gazette) II 2008, 852.

²³⁵ *O.P.P.*, above fn.162, 76 F.2d 11 (12) (2d Cir. 1935); *Castle Harbour*, above fn.129, 459 F.3d 220 (2006) at 232 and following (different to lower court *TIFD III-E v U.*, S. 342 F.Supp.2d 94 (D.Conn.2004)).

²³⁶ See in this regard Osterloh-Konrad and Lagdali, above fn.181, 406, 408.

²³⁷ Compare CTA 2010 ss.1000(1)F, 1015, 1032; Harris, above fn.16, 195 and following.

for whom certain additional preferences and disadvantages of independent entrepreneurial activities do not come into play.

As is the case in income tax law, the question arises in corporate tax law whether equity holdings can only be created on the basis of membership rights or whether they can also be created on the basis of a mere loan contract. Indeed, the demarcation receives a special hue here. This is because partnership law is regularly concerned with the question whether the legal relationship between the capital investor and the capital recipient, where the factual circumstances are those of a joint business enterprise, can be subsumed by a partnership in the legal sense or whether it remains within the realm of contracts of exchange. In contrast, in corporate tax law, a corporation with regular shareholders already exists in each case and the question arises, which holders of hybrid financial instruments can and must be recognised as holders of equity above and beyond this core group. In other words: the question is not whether capital investors and capital recipients jointly operate an enterprise (which is the question asked in income tax law), but rather whether the capital investor is involved in an existing business corporation as an additional contributor of equity.

This leads to the difficult question whether formal membership of a company limited by shares or of another corporate tax subject is a mandatory requirement for the treatment of a capital investor as an investor of equity or whether the pre-requisites for the classification of the investment as equity can also be created on a contractual basis. Further, the question must be answered whether in certain situations a shareholder, with consideration for statutorily or contractually reduced financial entitlements or control and voting rights, can be designated as a simple lender of capital for tax purposes. In answering this it can be seen that most states proceed “asymmetrically” and seldom classify corporate law equity as debt for tax purposes, whereas contractual creditor positions are more often rated as equity from a tax perspective.

In most of the examined legal systems, the corporate law shareholders of a corporation are in principle always judged to be investors of equity regardless of the concrete configuration of their legal position. Thus under Brazilian,²³⁸ German,²³⁹ Greek²⁴⁰ and Austrian law, distributions to preference shareholders are generally classified as dividends, without regard to the concrete configuration (variable versus fixed interest, participation in the proceeds of liquidation, withdrawal of voting rights). The same applies in Switzerland for participation certificates²⁴¹ and participation rights,²⁴² which are similar to German non-voting shares. French and British law are also heading in this direction and apply the rules regarding dividends fundamentally to all payments to members, in spite of the high degree of malleability of *actions de préférence* and

²³⁸ See Law No.6404/76 Art.17 in conjunction with Law No.6404/76 (DOU December 17, 1976) Art.203.

²³⁹ Intemann in Herrmann, Heuer and Raupach, above fn.152, §20 note 50.

²⁴⁰ 2190/1920 Art.3. The level of fixed dividends can be set in a number of ways but must always be objective.

²⁴¹ Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.c s.1; P. Locher, *Kommentar zum DBG, I. Teil* (Basel: Therwil, 2001), Art.20 para 75; Bundesgesetz über die Verrechnungssteuer Art.4 para.1 lit.b.

²⁴² Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.c s.1; Reich in M. Zweifel and P. Athanas (eds), *Kommentar zum Schweizerischen Steuerrecht—I/2a—Bundesgesetz über die direkte Bundessteuer (DBG)*, 2nd edn (Basel: 2008), Art.20 para.39.

preference shares.²⁴³ Even *redeemable shares*, which can be prematurely redeemed, are subject to this formal classification as equity.²⁴⁴

It is in any case worth noting that in France and the UK doubts are being raised about this formal view when the question in a concrete case does not concern the non-deductibility of dividends at the level of the company but rather concerns the exercise of the favourable participation exemption at the level of the shareholder for dividends and profits on disposal. Thus in France it is debated whether the participation exemption for payments to the holders of *actions de préférence* is available if the level of distributions is either determined in advance or distributions are paid without the need for a resolution regarding the use of the profits.²⁴⁵ This difficulty is once again especially differentiated in British legal practice and recent legislation regarding *disguised interest/shares accounted for as liabilities*.²⁴⁶ It appears worthy of note that in both the French and UK legal systems the participation exemption for this type of “disguised interest” is prohibited or a prohibition is debated, without consideration being given to the flip-side, specifically, the deductibility of these payments at the level of the company.

US tax law in particular offers the antithesis to the very formal observations of most examined legal systems; here the *multi-factor-test* is applied equally for both membership and contractual holdings.²⁴⁷ Given that US corporate law grants the parties a large degree of configuration freedom and that the corporate laws in the individual states are differently tailored, such an overarching *substance over form* consideration makes a lot of sense. Thus, US courts have treated certain *shares as debt* for tax purposes when the economic configuration approximates to that of a debt holding, for example, when a loan is converted to *preferred* stock and at the same time a regular payment of fixed returns is assured to the shareholders.²⁴⁸ In such a case, the classification as interest is accepted both in the hands of the recipient of the capital as well as in the hands of the capital investor: the amounts paid are deductible when calculating the taxable income of the corporation.

However, it would be remiss to assume that the “membership” or “contract” classification of a financial instrument under US tax law plays no role at all; in borderline cases this classification can tip the balance.²⁴⁹ Thus, it appears that there are cases where payments to the holders of *preferred stock* are classified as dividends whereas the almost identical arrangement of a debt holding leads to the deductibility of the capital returns as interest (*trust-preferred securities*).

A particularly progressive treatment has arisen in Australian tax law. Here, the legislature and administration have to a large extent freed themselves of the corporate or contractual classification of financial instruments with special *debt-equity-rules*.²⁵⁰ The emphasis is on material-legal criteria, above all the security of the right to repayment of the given loan.

In the Netherlands, in a case on redeemable preference shares, the Dutch Supreme Court recently held that instruments that qualify as equity from a legal perspective cannot be reclassified

²⁴³ Osterloh-Konrad and Lagdali, above fn.181, 408. Cf. Harris, above fn.16, 192, 198.

²⁴⁴ cf. CTA 2009 s.521A and following (*e contrario*); see also Harris, above fn.16, 198.

²⁴⁵ D. Ohl, “Valeurs mobilières” in *Répertoire de droit des sociétés* (Paris: Dalloz, 2005), 28.

²⁴⁶ CTA 2009 s.486A and following, s.521A and following.

²⁴⁷ *Fin Hay*, above fn.173, 398 F.2d 694 (1968) at 696 and following.

²⁴⁸ *Bowersock Mills & Power Co v CIR*, 172 F.2d 904 (10th Cir. 1949) at 908.

²⁴⁹ *Monon Railroad v Commissioner*, 55 T.C. 345, 357 (1970); *Hunt*, above fn.172, T.C. Memo 1990-248 (1990).

²⁵⁰ Div 974 ITAA97; Woellner et al., above fn.224, para.22-010 and following.

as debt for tax purposes even if the shareholder can terminate the provision of capital after several years and the capital has debt-like features such as a fixed remuneration and a risk profile structured similarly to that of a creditor.²⁵¹ In order to ensure legal certainty, the Supreme Court did not make an exemption to this rule in situations in which at the time of the payment of the capital the risk that the capital actually will be used for the payment of debts seems negligible and therefore, to that extent, there is hardly a difference between capital and debt.

Most examined tax systems deal more easily with the question of whether and to what extent contractual holdings can be classified as “equity”—with the result that the capital returns cannot be deducted by the corporation, payments to the recipients may be completely or partly tax-free and profits on disposal and losses in value result in different legal consequences.

The strictest treatment can be found in French²⁵² and Swiss²⁵³ law, where all payments on contractual holdings are considered to be deductible for the corporation and a differing classification is only discussed in exceptional cases. German and Austrian²⁵⁴ law appear to be more closely orientated with the economic content. Here, according to legislative directives, contract-based participation rights, as long as they are endowed with rights to profits and a participation in the proceeds of liquidation, are treated as “share-like”.²⁵⁵ In Greece, similar rules apply for income bonds²⁵⁶ and foundation bonds.²⁵⁷ In Brazil, contractual participation rights are subject to corporate tax at the level of the company, but the dividends are not tax-free at the level of the recipient.²⁵⁸ In the Netherlands, a “membership loan”, which largely approximates to a share, is treated as equity for tax purposes for both the capital investor as well as the recipient of the capital—with the corresponding consequences for the treatment of returns on the capital.²⁵⁹ The law of the US appears to be particularly flexible, where contractual holdings can, to a significant extent, be classified as equity for tax purposes.

The law of the UK plays a special role. It follows fundamentally the private law characterisation of a capital holding for tax purposes, but a special legislative regime has been established with regard to restrictions on the tax deductibility of profit-dependent payments.²⁶⁰

If one compares “classic” equity and “classic” debt, at first glance a difference can be seen not only in the type and extent of the remuneration and the risk but also in the corporate law (and if need be court) process for the enforcement of the right to payment in each case. For the holder of loan receivables, the amount and timing of payments required from the debtor is clear

²⁵¹ Dutch Supreme Court, February 7, 2014, NTFR 2014/739.

²⁵² Osterloh-Konrad and Lagdali, above fn.181, 410.

²⁵³ Bundesgesetz über die direkte Bundessteuer Art.65 and Art.58 lit.b *e contrario*.

²⁵⁴ See, for instance, S. Kirchmayr, “Die steuerliche Behandlung von Genußrechten an Kapitalgesellschaften” in Zöchling et al. (eds), *Rechnungslegung, Prüfung und Beratung—Festschrift KPMG* (Vienna: LexisNexis, 1996), 125, 133 and following.

²⁵⁵ Compare KStG (Körperschaftsteuergesetz—Corporate Tax Act) §8 para.3 s.2 alt.2.

²⁵⁶ N. 2190/1920 Art.3b and N. 3156/2003 Art.14.

²⁵⁷ N. 2190/1920 Art.15(1) and following, and KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Art.24(1).

²⁵⁸ Concerning the tax treatment of partes beneficiárias, see Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Arts 463 caput, 635, 669, 670 caput and 671 in conjunction with Law No.1598/77 (DOU December 27, 1977) Art.58 sole paragraph (parágrafo único), Law No.7713/88 (DOU December 23, 1988) Art.7 II and Law No.1979/82 Art.3.

²⁵⁹ G. De Keizer and M. Sunderman, “The Debt-Equity Conundrum, The Netherlands’ branch report” (2012) 97b *Cahiers de droit fiscal international* 489, 489–490, 498.

²⁶⁰ CTA 2010 ss.1000(1)F, 1015, 1032; Harris, above fn.16, 189, 195 and following.

from the outset. If these payments are not made when due, court proceedings can be initiated for the receivables and these can be realised by foreclosure of the debt or as part of insolvency proceedings. For the shareholder in a corporation the situation is different. Dividends can only be distributed if corresponding profits have been determined (or a free reserve has been released). In addition, a decision of the responsible corporate body (general meeting or the board of directors) must be reached with respect to the use of the accrued profit—retention or distribution. In doing so, the limits on distribution for the protection of creditors (statutory capital or at least over-indebtedness) must be adhered to. A shareholder in a corporation has no direct right to sue for the payment. Against this background, in US tax law the direct enforceability is considered to be a strong indicator that the position is one of a creditor in an income tax sense.²⁶¹

This procedural differentiation can only be partially removed by arrangements between the parties. In many countries, preference shares can carry the right to fixed interest payments, however the payment of this annual fixed amount is dependent on the determination of a profit and a corresponding resolution to distribute such.²⁶² To the extent that *mandatory dividends* are agreed in the US, the board must make a decision to distribute notwithstanding the fixed provision and the board must verify that a distributable profit is available (or other free funds). Conversely, there is significant room to make the payment of contractual returns dependent on the assessment and determination of the company.

Against this background, it should first be examined which financial modifications can result in distributions on shares being re-classified as returns on debt. In doing so it must be recognised that certain financial specifics of share capital cannot be privately altered. These include essentially: the subordination in insolvency to all debt holdings and—to the extent legislatively prescribed—the ban on the distribution of the statutory capital.

Some states fundamentally prohibit the re-classification of shares as debt (Germany, Austria, Switzerland²⁶³); however these are the same states in which there is decidedly little flexibility to privately determine the configuration of shares in any case²⁶⁴ (for example, the legal institution of *redeemable shares* does not exist or—to give another example—shareholders always have the right to participate in the proceeds of liquidation).

In contrast, in other jurisdictions a change in perspective can occur if, economically, the capital made available is serviced with fixed interest. Under British law this result is linked to the questions of whether the earnings represent financial remuneration for the use of money for a certain period of time, whether the interest rate is comparable to normal market rates and whether (other than in the insolvency of the debtor) there is no practical likelihood that the earnings

²⁶¹ Plumb, above fn.176, 406, 430 and following; regarding the court enforceability see *Deutsche Asia Pacific Finance Inc v Commissioner of Taxation* [2008] FCA 1570 (October 22, 2008) (Federal Court of Australia). Judge Edmonds rhetorically asked “how would one plead the right or entitlement in an action to enforce the right or entitlement?” Indeed, in such a case *Deutsche Asia Pacific Finance Inc.* would argue that the entitlement was dependent on net income of *Industrie LP*. It was held that the entitlement to the return was calculated wholly by reference to profits and therefore the Commissioner was entitled to apply interest withholding tax at the full domestic rate under Art.11(9) of the DTA Australia/US.

²⁶² e.g. in Germany (AktG—German Stock Corporation Act §57 para.3 and Hüffer, above fn.52, §139 note 2) and France (Moulin, above fn.57, 24, 38).

²⁶³ Bundesgesetz über die direkte Bundessteuer Art.65.

²⁶⁴ Meier-Hayoz and Forstmoser, above fn.47, §16 para.279 and following.

promised on the acquisition of the share will not be produced.²⁶⁵ In doing so the inclusion of the amounts within the taxable profits of the corporation is not called into question, rather it is only the re-classification as (taxable) interest at the level of the capital investor that is prescribed. There is a comparable discussion in French law regarding the removal of the participation exemption for shares with fixed distributions that have been determined in advance.²⁶⁶

One only finds a full re-classification in the US, where fixed interest payments for share capital can lead to the assumption both at the level of the capital investor as well as at the level of the recipient of the capital that interest payments are being made on an *indebtedness*.²⁶⁷ However, in the US *adjustable rate preferred stock*, which provides for fixed remuneration on the issue price and redemption price (and which, in order of priority, is located between regular equity and debt) is still classified as equity if the payment is dependent on the availability of distributable profits and must be preceded by a board resolution.²⁶⁸

The agreement that a share is redeemable by the issuer or the investor (*redeemable shares*) including a fixed end date for a shareholder's participation (*mandatory redeemable share*) is not in any case taken to be a reason for the re-classification of the share as debt (this is the legal situation in Brazil,²⁶⁹ France,²⁷⁰ Greece²⁷¹ and the UK²⁷²). However it must again be noted that in the US, the term of a financial instrument is one of the factors that must be considered as part of the *multi-factor-test*.²⁷³

There are very different answers to the question of which type of result-dependent remuneration results in a re-classification of debt as equity of corporations. Particularly strict is, first, French law, which follows the private law classification. Variable remuneration for a loan fundamentally changes nothing with regard to the deductibility of capital returns.²⁷⁴ However, where the capital investor participates in losses and has sufficient control rights, the silent partnership rules and thus the independent corporate tax liability of this undisclosed partnership must be applied.²⁷⁵

The requirements of Brazilian,²⁷⁶ German and Austrian²⁷⁷ law are also quite distinct, here normal income bonds and other loans with variable remuneration are classified in principle as debt. This is also true of debt holdings with a participation in losses (such as silent participations). It is only when the capital investor additionally shares in any profit on liquidation of the enterprise (in the

²⁶⁵ CTA 2009 s.521C(2).

²⁶⁶ Ohl, above fn.245.

²⁶⁷ *Fin Hay*, above fn.173, 398 F.2d 694 (1968) at 696; *John Kelley Co v Commissioner (John Kelley)*, 326 US 521 (1946), 526.

²⁶⁸ Rev Rul. 90-27 (Jan. 1990), 1990-14 I.R.B. 7.

²⁶⁹ Law No.6404/76 (DOU December 17, 1976) Art.19 in conjunction with Art.44 caput, Law No.9249/95 (DOU December 27, 1995) Art.10 in conjunction with Art.22 §4; E.P. Bifano, *O mercado financeiro e o imposto sobre a renda* (São Paulo: Quartier Latin, 2008), 274.

²⁷⁰ Where all *actions de préférence* regardless of their particularities are treated as equity by tax law, see A. Lagarrigue, "Titres super-subordonnés, actions de préférence: dette ou capital?" [2005] *Revue de Droit des Affaires Internationales* 540, 547.

²⁷¹ N. 2190/1920 Art.17b and KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Art.106(8).

²⁷² Compare CTA 2009 s.521A and following *e contrario*.

²⁷³ *Fin Hay*, above fn.173, 398 F.2d 694 (1968) at 696 and following; *Gilbert*, above fn.163, 248 F.2d 399 (2nd Cir. 1957) at 402 and following; Plumb, above fn.176, 406, 413 and following.

²⁷⁴ Raimbourg and Boizard, above fn.61, para.26.111 and para.36.53.

²⁷⁵ Administrative instruction BOFiP-Impôts BOI-BIC-CHAMP-70-20-60-20120912, above fn.149, paras 50 and 180.

²⁷⁶ Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Art.730 IV.

²⁷⁷ Krejci and van Husen, above fn.26, 54, 55.

sense of a participation in the latent gains) that “share-like” participation rights are treated like shares for tax purposes.²⁷⁸ Thus, there are greater asset participation requirements for the classification of participation rights as equity than there are for preference shareholders.

Further, in the Netherlands profit-dependent loans are re-classified as equity if the loan is given a lower ranking and in addition has a term of at least 50 years or the capital must ultimately only be repaid if the company is insolvent or goes into liquidation.²⁷⁹ However, from 2002 to 2007 there were significantly stricter rules, which prevented the deductibility of the payment of returns on profit-dependent loans for loans of shorter terms as well.²⁸⁰

The UK plays a special role. Here, the contractual classification of creditor rights is, in principle, observed for the classification of hybrid debt holdings. However, result-dependent capital returns are not deductible at the outset, independently of the underlying instrument and thus, without consideration for the drawing of the line between corporate and contractual holdings, only fixed interest payments are deductible.²⁸¹ Multiple exceptions to this fundamental principle are recognised in the legal environment in the UK that on the one hand consider the residence of the capital investor and on the other hand the status of the capital investor as a natural person or corporation.²⁸²

In the US, profit dependence can be a strong indicator of the acceptance of risk and thus the status as *equity*.²⁸³ However, the Internal Revenue Service has recognised *registered subordinated debentures*, which link a fixed interest yield with a low, contractually fixed profit share, as debt.²⁸⁴

In the above mentioned countries—the Netherlands, UK and the US—the question of whether a fixed interest rate falls away completely in the absence of profit or whether the payment of the interest is simply postponed until positive operating results are generated or until final liquidation (*cumulative bonds*) plays a significant role in the demarcation between deductible and non-deductible capital returns.^{285,286}

On the other hand, a special role is played by financial instruments that entitle their holders to a share in profits but are not based on an investment of capital and thus also carry no right to repayment. French law recognises one such instrument among the different forms of corporate membership (*actions de jouissance*²⁸⁷) and applies to it the rules regarding dividends as if this were self-evident. Most legal systems allow these holdings, in contrast, only as contractual holdings. However, payments on these holdings are treated in some countries wholly or partially

²⁷⁸ Compare KStG (German Corporate Tax Act) §8 para.3 s.2 alt.2.

²⁷⁹ De Keizer and Sunderman, above fn.259, 489–490.

²⁸⁰ J. Müller, *The Netherlands in International Tax Planning*, 2nd edn (Amsterdam: IBFD, 2007), 67 and following.

²⁸¹ Montagu, above fn.160, para.2.84 and following.

²⁸² Compare CTA 2010 ss.1000(1)F, 1015, 1032; Harris, above fn.16, 196.

²⁸³ *Roth Steel*, above fn.173, 800 F.2d 625 (1986) at 631; R.B. Madison, “The Deductibility of ‘Interest’ on Hybrid Securities” (1986) 39 *Tax Lawyer* 465, 475 and following.

²⁸⁴ IRS Revenue Ruling 68-54 (Jan 1968), 1968-1 Cumulative Bulletin 69.

²⁸⁵ De Keizer and Sunderman, above fn.259, 498 and following.

²⁸⁶ Montagu, above fn.160, para.2.84.

²⁸⁷ See Code de Commerce Art.L.225-198 and Art.L.225-199.

like dividends (in Brazil (participation certificates),²⁸⁸ Greece (foundation bonds)²⁸⁹ or in Switzerland (participation certificates)²⁹⁰). In Germany and Austria, it was debated for a long time whether, for participation rights, a lack of participation in the proceeds of liquidation is a better argument for or against their equal treatment with dividends: ultimately the judiciary held in favour of the double requirement “profit share *plus* share in liquidation” on the basis of the wording of the law.²⁹¹

A further modification of a typical loan contract is the waiver of a fixed date for repayment. *Perpetual bonds* can be found above all in the UK and in the US where the debtor can freely decide when to make the repayment or where the repayment is dependent on certain circumstances that can be influenced by the debtor (for example, the disposal of underlying assets).²⁹² The receivable must be settled at the latest in the insolvency or liquidation of the debtor-company. In the UK these bonds are thus recognised as debt.²⁹³ This is also true in principle in the US, however here the maturity date is rated as a possible factor in the overall classification—above all when there is factual doubt regarding the actual future repayment.²⁹⁴ The same applies to the Netherlands where the combination of a long term and profit-dependence of the remuneration can justify the classification as equity.²⁹⁵ In Germany and France “perpetual” bonds are, in contrast, as a rule held to be debt,²⁹⁶ however the German financial administration favours the classification of profit-dependent “perpetual” bonds as participation rights.²⁹⁷ At the end of the day, agreements that allow the enterprise to defer the payment of interest according to a fixed schedule or in accordance with the financial assessment of the corporate management are also typical.²⁹⁸ This deferral yields different tax consequences, however, according to whether interest payments actually fall away or whether the full receivable can be enforced at the latest in the insolvency of the debtor (in priority to equity). In the latter case, there is ultimately a fixed obligation to pay capital and interest—as for a cumulative Zero-Bond—and thus a structure that can be assigned to debt.²⁹⁹

²⁸⁸ Regarding the tax treatment of partes beneficiárias, see Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Arts 463 caput, 635, 669, 670 caput and 671 in conjunction with Law No.1598/77 (DOU December 27, 1977) Art 58 sole paragraph (parágrafo único), Law No.7713/88 (DOU December 23, 1988) Art.7 II and Law No.1979/82 Art.3.

²⁸⁹ KFE (Kodikas Forologias Eisidimatos—Income Tax Act) Art.24(1).

²⁹⁰ Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.c; Reich, above fn.242; Bundesgesetz über die Verrechnungssteuer Art.4 para.1 lit.b.

²⁹¹ See Nagele and Lux in P. Jabornegg and R. Strasser (eds), *Kommentar zum Aktiengesetz*, 5th edn (Vienna: Manzsche Verlags- und Universitätsbuchhandlung, 2011), §174 para.29.

²⁹² For Germany see M. Haisch in M. Haisch and M. Helios, *Rechtshandbuch Finanzinstrumente* (Munich: Beck, 2011), §1 note 109; for the UK see Walmsley, above fn.85, 255.

²⁹³ Compare Hannam, above fn.106.

²⁹⁴ *Fin Hay*, above fn.173, 398 F.2d 694 (1968) at 698; *Gilbert*, above fn.164, 248 F.2d 399 (2nd Cir. 1957) at 406 and following.

²⁹⁵ De Keizer and Sunderman, above fn.259, 498 and following.

²⁹⁶ For France see Galland, above fn.116, 1125.

²⁹⁷ German Federal Ministry of Finance, Decree of December 8, 1986 [1987] *Betriebs Berater* 667.

²⁹⁸ Compare Hannam, above fn.106.

²⁹⁹ Compare Hannam, above fn.106.

The subordination of an obligation plays fundamentally no role. This is true not only in Germany,³⁰⁰ Switzerland³⁰¹ and in the UK,³⁰² but in France as well, where especially graduated levels of priority are found in practice (particularly *titres super-subordonnés*³⁰³). However, a limited indicative effect is ascribed to this feature under the law of the Netherlands as well as in US law, and to the actual probability of default on interest payments or the repayment of capital.³⁰⁴

In terms of the classification of debt holdings as equity, administrative rights as such play as good as no role—even under US law, massive requirements to seek the creditor’s consent in creditor *covenants* are not seen as a reason to declare the creditor to be a holder of equity.³⁰⁵

From the point of view of a corporate tax classification, compound financial instruments present a special challenge. These are, primarily, capital investments designed to allow an exchange of rights for membership or vice versa. Convertible debt, which grants the holder of the bond the right to demand the conversion of the bond to shares in the issuing enterprise, is particularly widespread. Indeed, this right to choose can also be given to the issuer itself (*reverse convertibles*); fixed conversion dates that are binding for all parties are also possible (*mandatory convertible bonds*). US law recognises *convertible shares* as well, which convert to debt on the basis of their design or on the happening of a certain event or appointment.³⁰⁶

An oft applied—and at the outset clear—treatment seeks to distinguish between the two phases and to apply the debt rules for the period of time during which a bond exists and the equity rules for the period of time during which a share exists (this is the legal situation for convertible bonds in Brazil,³⁰⁷ Germany,³⁰⁸ France,³⁰⁹ Greece,³¹⁰ Austria³¹¹ and in the UK³¹²). In these states, however, significant problems result from the fact that the interest rate of convertible bonds is set low due to the prospects of future growth in value (*convertible bonds*) or is set high due to the prospects of future decreases in value (*reverse convertible bonds*). This increase or decrease in the interest burden must be set so as to have a sensible relationship to the appreciation and depreciation in the bond’s value as well as to the profits and losses at the time of the conversion. The tax effects are on the other hand very significantly dependent on whether and how increases and decreases

³⁰⁰ Lehmann in K. Bösl and M. Sommer, *Mezzanine Finanzierung* (Munich: Beck, 2006), 258.

³⁰¹ Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.a; Broda, above fn.169; Baumgartner, above fn.169.

³⁰² Compare Tiley, above fn.174, 263, 309.

³⁰³ Galland, above fn.116, 1111 and following.

³⁰⁴ De Keizer and Sunderman, above fn.259, 489–490, 498 and following.

³⁰⁵ Bittker and Eustice, above fn.173, 4.03 [2] [h]; Madison, above fn.283, 477 and following.

³⁰⁶ Revised Model Business Corporation Act §6.01(c)(2).

³⁰⁷ Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Art.729 §3; Normative Instruction of the Brazilian Federal Tax Authority (Instrução Normativa da Receita Federal do Brasil—IN RFB) No.1022/10 Art.37 §5; R.Q. Mosquera, “Tax treatment of hybrid financial instruments in cross-border transactions” (2000) 85a *Cahiers de Droit Fiscal International* 195, 203; Bifano, above fn.269, 275.

³⁰⁸ Regarding the special difficulty of the classification of a profit-dependent convertible bond with interest as a participation right see Stein in C. Herrmann, G. Heuer and A. Raupach, *Körperschaftsteuergesetz* (Cologne: Otto Schmidt, 2012, EL 253), §8 note 187.

³⁰⁹ Raimbourg and Boizard, above fn.61, para.36.81.

³¹⁰ N. 3156/2003 Art.14.

³¹¹ See Bertl in M. Bischof and E. Eberhartinger (eds), *Hybride Finanzierungsinstrumente* (Vienna: Linde, 2005), 99, 112.

³¹² Southern, above fn.160, 138 and following. The division, for accounting purposes, of convertible bonds before the conversion into a loan component and a fictional derivative financial instrument is reproduced for corporate tax purposes (*bifurcation*), cf. HMRC, *Corporate Finance Manual*, CFM37670.

in the value of capital investments are caught at all (*capital gains taxation*, inclusion within operating or private assets), whether these can be set off against current returns and how a tax law system treats exchange processes (deferral of the realisation of profits?). In contrast, there is a clear division in accordance with periods of time for the company's current payments to investors. Only the UK applies the special rules regarding the non-deductibility of profit-dependent capital returns to interest payments on certain convertible bonds that are not traded on a recognised stock exchange.³¹³

An early classification of such bonds as equity for tax purposes is only endorsed in rare cases. Thus, an issue under German law is whether bonds that combine a profit-dependent payment of interest with a conversion right have to be classified as "participation rights" and thus treated like shares from the outset.³¹⁴ Even in form-strict France, consideration is given to whether *titres subordonnés à durée indéterminée remboursables en actions (TSDIRA)*, that is, subordinate mandatory convertible bonds without a pre-determined conversion date, could, by way of exception, be viewed as equity before the conversion.³¹⁵

The situation is once again different in the US. Here, under certain conditions, a bond can be classified as equity before the exchange (and thus ongoing capital returns as dividends). This is primarily the case when the economic risk of a loss in value of the underlying share is borne by the investor—whether this is because the bond's repayment amount is set so low that the investor would opt for a conversion even if the shares had decreased in value or because the issuer has the right to convert at a pre-determined share price.³¹⁶

Shareholder loans present a special difficulty that is dealt with on several—court and legislative—levels in many countries. They are increasingly subject to special legislative rules³¹⁷ particularly in the event of cross-border financial transactions (within company structures), which, among other things, contemplate a re-classification of interest from shareholder loans as dividends.

From the authors' point of view it remains to note that most legal systems do not qualify shareholder loans as "equity" in accordance with the general rules of corporate tax law. Interest payments on shareholders loans are thus in "domestic cases" fundamentally deductible at the level of the corporation (in so far as the above criteria do not suggest that a different judgement is more appropriate). A different judgement can occur at the level of the shareholder if loans are granted in a company crisis and the later loss of these loans must be distinguished from tax-irrelevant expenses of the shareholding.

In the US, given that income taxation imposes double taxation on corporate profits, an excessive judicature has developed over several decades at the level of the corporation that classifies shareholder loans as equity in a way that is difficult to predict. Elements which play a significant role here are the shareholder's risk of loss, the contractual subordination of the loan in relation to third party debt holdings, the parallelism of the debt finance with the level of the shareholding,

³¹³ CTA 2010 ss.1000(1)F, 1015(3). Compare Harris, above fn.16, 195.

³¹⁴ Stein, above fn.308.

³¹⁵ Lagarrigue, above fn.270, 551 and following.

³¹⁶ IRS Revenue Ruling 83-98 (July 1983), 1983-2 Cumulative Bulletin 40 (*adjustable rate convertible note*).

³¹⁷ More regarding the special rules Brown, above fn.10, 35 and following.

the voluntary waiver by the shareholder-creditor of the right to interest payments in a crisis and the relationship between the equity and the debt.³¹⁸

A new approach to debt and equity under corporate income taxation

The attempt to develop a convincing demarcation between equity and debt holdings from the point of view of corporate tax law is subject to the fundamental difficulty that this demarcation brings about other fundamental and specific legal consequences depending on the design of the relevant corporate tax system. At the forefront of this difficulty is the fact that some tax systems tax returns on equity more highly while other legal systems strive for financial neutrality in the economic result and thus compensate the taxation of dividends at the corporate level with relief in the basis of assessment or in the taxation rate at the level of the shareholder. This ushers in completely different teleologies:

1. In a tax system designed to tax equity earnings more highly, one must query, for which capital holdings is this increased taxation objectively justified. This is no easy task, because this double taxation occurs as a rule with no clear objective. If one justifies the additional taxation of corporate profits with the notion of a “return” for making a limited liability legal form available, one could only confront a close circle of corporate law “members” with this special burden. If one justifies the double taxation of corporate profits further with the notion of a special “ability to pay” or “taxable power” of the legal entity, one enters a circular argument, because the answer to the question of the extent of this “ability to pay” is in fact identical to the answer to the question regarding the financial boundaries of this entity comprised of members. The inevitable uncertainty of deductions from the apparently objective “taxable power” of a corporation can be exemplified by the different opinions of the German Imperial Fiscal Court and its successor, the Federal Tax Court, on the following question: are the earnings on a participation right within the area of application of corporate tax if they burden the corporation (namely through a share in profits and liquidation) just like earnings on a share or can a lesser burden (namely only with a share of profits) also lead to corporate income tax treatment?³¹⁹
2. Given the fact that any differential tax burden on earnings from equity and debt is difficult to justify, this absence of a clear teleology for the demarcation line is substituted by a general desire to resist any manipulation of this borderline by the taxpayers. In other words: the differential burdening of equity and debt has no legitimate political purpose—however one wishes to avoid a situation where it becomes the object of tax-avoiding design. This has the result that an “economic perspective” or a “substance over form” approach comes into play, which primarily queries the “similarity” of a hybrid form of finance with classic equity and debt holdings, without clearly spelling out which financial entitlements or control rights

³¹⁸ In detail Bittker and Eustice, above fn.173, 4.04.

³¹⁹ Compare RFHE 36, 43 = RStBl. 1932, 746 and BFH (*Bundesfinanzhof*—Federal Fiscal Court) BStBl (*Bundessteuerblatt*—Federal Tax Gazette) II 1996, 77.

of an instrument are critical for the determination of the “similarity”. A consequence of such a “purpose-free” test of comparability is the *multi-factor-test*, well known from US law, which seeks a classification from an overall consideration of all elements of the financial instruments.³²⁰ It is evident that this offers no answer in terms of the development of a clear borderline in the “continuum” of financial instruments.

Against this background, an explanation must confine itself to a few formal points. For those tax laws that consciously prescribe a double taxation of returns on equity, the following principles must be considered:

1. Equity’s “core area” is comprised of the classic membership holdings (shares in public and private corporate entities).
2. If and to the extent that a membership holding is modified, there is in principle no reason to digress from the classification as an equity holding for tax purposes. This remains true even if a share approximates a contractual debt holding from an “economic perspective”, for example, where a fixed interest return is combined with the removal of voting rights (so far as allowed). The legal basis for the double taxation of corporate profits lies—as illustrated—exclusively in the formal link to the corporation’s own legal ability and at the same time to the shareholder’s membership of the corporation.
3. A subsumption of contractual capital participations within the concept of equity should only be contemplated if the financial instrument is completely consistent with a classic “share” or “GmbH-share” other than the contractual character of the instrument. Thus, one can treat participation rights and other contractual holdings, which combine a profit share for the capital investor with a participation in the proceeds of liquidation of the enterprise, like shares as equity holdings. For other debt holdings with a different make-up—for example profit-participating loans, typical silent partnership shares, income bonds, “perpetual” bonds, high interest bonds, etc.—there is no reason for double taxation.
4. This also applies if a similar combination of privileges could be brought about for membership rights as well by “downgrading” financial positions and control rights. This means that in a “grey area” between classic equity and classic debt the classification depends on the legal form chosen in each case (membership or loan contract). That is indeed to be assumed, because the teleology of the law does not assist further here and to that extent it appears that the taxpayer is offered the right to choose. In other words: there is no reason to subject the earnings from a hybrid contractual participation to double taxation only because there are comparable membership rights whose earnings are subject to this double taxation. Instead, one can say that it is exactly the double taxation that should only have to be borne in clear cases, considering that its *ratio legis* is difficult to explain and very formally defined.

³²⁰ *John Kelley*, above fn.267, 326 US 521 (1946) at 530; *Roth Steel*, above fn.173, 800 F.2d 625 (1986) at 630.

The teleology of corporate tax takes a completely different direction if the interaction between the taxation of the corporation and the taxation of the shareholders has the objective of producing an overall single taxation of the taxable profits. This is primarily the case if the taxation of the capital returns at the level of the corporation corresponds to a complete exemption from taxation at the level of the recipient (as is often the case for, for example, *intercompany dividends*) or at least a reduction of the basis of assessment or the rate of taxation (as is often the case for natural persons as shareholders). This system is implemented with particular consistency in Brazil, where a uniform taxation rate is applied on the one hand to dividends at the level of the corporation and on the other hand to interest at the level of the shareholders.³²¹

In these systems, the demarcation between equity and debt primarily serves to determine whether the tax exemption or reduction takes effect at the level of the corporation (debt) or at the level of the shareholders (equity). This means in principle that a classification of capital holdings as equity or debt must be made but that this generally should not have any effect on the actual taxation. The thinking behind single taxation would thus allow a completely formal demarcation (for example in accordance with the conceptual pair “membership versus loan contract”) as long as it is guaranteed that each capital return will be subject to the desired level of taxation at one of the affected levels.

The goal of a material “single taxation” of the profit generated in a corporation experiences its first important specification due to the requirement to avoid temporal and factual “tax gaps”. The demarcation between equity and debt cannot allow a capital return to be deductible for the corporation if it does not (yet) accrue to the capital investor for tax purposes. In other words: all returns on capital that are (or can be) retained by the corporation must be caught at the level of the corporation for tax purposes.

This requirement corresponds to the legislative purpose of corporate income tax as an effective pre-payment of the shareholder’s subsequent income tax. If the corporate income tax is primarily levied in order to prevent a (temporary) tax exemption for retained enterprise profits, then every return on capital that can be retained by the company must be consistently classified as earnings on equity. To this extent, the concept of the “tax gap” enables a clear teleological demarcation of equity from debt: if and to the extent that the organs of the company (general meeting, board) can decide via resolutions whether the results generated by the enterprise will be paid out or reinvested, corporate tax must take hold of this component of income.

This also corresponds with the traditional understanding of “income” in the sense of a subjective figure aligned with the taxpayer’s personal ability to pay. A fundamental feature of the traditional concept of income in the sense of the “ability to pay” is the taxpayer’s command of financial means: earnings which the taxpayer enjoys unconstrained access to increase his income³²²; earnings where another body can determine their use cannot be attributed to this income. From this, a simple division is created: those parts of income where the company (respectively its

³²¹ Concerning the Brazilian tax treatment of dividends, see Law No.9249/95 Art.3 in conjunction with Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Arts 541 and 542 as well as Law No.9249/95 (DOU December 27, 1995) Art.10. Regarding the tax treatment of interest, see Normative Instruction of the Brazilian Federal Tax Authority (Instrução Normativa da Receita Federal do Brasil—IN RFB) No.1022/10 Art.55; Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Arts 373 and 374; Law No.8981/95 (DOU January 23, 1995) Art.76 I and Art.76 §2.

³²² Tipke, *Die Steuerrechtsordnung*, 2nd edn (Cologne: Schmidt, 2003), Vol.2, para.4.21 and following.

decision-making bodies) can determine their distribution or retainment at the level of the company belong to the company's income, those parts of income where the capital investor alone can determine their use (particularly their withdrawal), are to be attributed to him. They increase his personal ability to pay.

It follows from this that earnings whose appropriation is subject to a resolution of the general meeting or for which the board has the discretion to declare them as *dividends* have to be classified as returns on equity. This means that the profit earnings of shareholders and other members of the corporation are to be classified, as a rule, as profits of the corporation and are not deductible as operating costs. This has an additional positive effect: as the company's organs have the ability to take account of the corporate taxation at the level of the enterprise when making a decision to distribute they can fine-tune the amount declared as dividend to the need to pay corporate income tax. The problematic situation does not arise where corporate tax must be paid by the corporation in respect of an amount that must be distributed in full to the investor.

This criterion can prove to be problematic if shareholders or other members of the tax-paying corporation are promised fixed interest payments, which is often the case for preference shareholders. However, the arrangements here are many and varied. For these cases the first step is to decide whether the simple existence of a formal requirement for a resolution is of itself sufficient to justify the classification as equity even if the company is legally obliged to make this resolution and to make the promised payment. This should be answered in the negative. The tax treatment should not be dependent on formal procedural steps but rather on the actual power of disposition of either the company or the capital investor. Promised payments can only be differently judged if and to the extent that the company (or the responsible organ) has at least a limited discretion, for example because it can withhold a distribution due to the current financing requirements of the company. Then it is able to retain the profits, which rules out a deduction for the capital returns. There is also a clear liability for corporate tax with respect to interest which does not have to be paid at all unless dividends are distributed to ordinary shareholders at the same time.

A second step is to examine whether the promised interest should also be deductible at the level of the company if the fixed interest payments can only be made from current profits or existing retained profits. In this case the company's profits are simply a numerical upper limit to the payments, and the liability to the shareholder is not itself called into question. Thus, in these cases one should affirm that it is a deductible return on debt. The situation is different if the payments can be deferred and paid from later profits. Then, a "tax gap" threatens, which has to be closed by the corporate income tax. The same applies if a payment of interest to preference shareholders is not possible because the capital must first of all be re-established. This has the result that obligations arise at the level of the company before revenue is realised at the level of the shareholder. The *cumulative-if-earned* payments must therefore be treated like real shares for corporate tax purposes.

If one accepts that the company's organs have the authority to retain profits, this means that the profit-dependence of capital remuneration as such should not play a critical role in the classification. Profit-dependent loans are an example to the contrary, where the lender can enforce its right to the capital returns at will. Here, as a rule, the company has no right of its own to decide (even if the determination of the profit share requires certain procedural steps under

accounting rules). Following this line of thinking, deductibility should only be ruled out for those contractual returns whose payment is dependent on the approval of a company organ (for example, payments on participation rights in accordance with annual dividends on shares).

Thus, the situation for corporate tax law remains the same as for income tax law: the profit dependency of a payment does not of itself prevent its deductibility. To this extent there should be no differentiation between fixed interest and variable remuneration; finally this is also true for hybrid and compound forms of return.

Given that returns on equity and debt should, as a starting point, be captured in the same way for tax purposes—and indeed only once—the question arises whether it matters if this return is primarily captured either at the company level (as is the case for dividends) or primarily at the level of the shareholder (as for interest). Here, problems can arise if the actual taxation is not only dependent on the amount and accrual of the return on capital, but also on additional facts and circumstances at the level of the shareholder or the company. At the forefront of the discussion in this regard is the existence of losses available for set-off in the hands of the shareholder or the company. This ability to off-set losses can be exploited through the choice of financial form if this choice means that the return on capital is taxed at the level (company or shareholder) at which losses are available for set-off.

These arrangements are primarily discussed in Australia, France and the UK.³²³ Hybrid instruments form the background where:

1. either debt is given with a profit share, so that losses from other sources can be offset against the taxable profits at the level of the capital investor; or
2. it is agreed that fixed interest payments will be made as a part of membership rights (*preference shares*) so that the tax liability (and thus the ability to set-off) for the capital returns is at the level of the company as earnings on equity.

The background to this difficulty is the concept of the personal taxation of income as a “synthetic” collective taxation of the revenue of a certain (natural or legal) person from various sources. The off-setting of losses pre-supposes that the same person generates both the positive as well as the negative revenue. The problem would not arise if the vertical or horizontal off-setting of losses between various sources of revenue were not allowed from the outset by the underlying tax law. The problem would also not appear if losses could be freely shifted between a company and its shareholders. Finally, the problem would not exist if a taxpayer in a pure loss situation received a “negative tax” and thus were not reliant on a set-off against positive revenue from other sources. Only a tax system linked to individual tax subjects and taxing their “total income” without granting a negative tax on losses has to answer the central question here, how should earnings on capital from hybrid financial instruments be subjectively assigned and thus, how should the ability to set off these earnings on capital against other losses of the capital investor or capital recipient be assigned?

In order to master this problem, British law primarily takes account of the classic distinction between a profit share and fixed interest. Earnings are predominantly classified as *disguised interest* and subject to the rules regarding earnings on debt if preference shareholders are to

³²³ Compare Tiley, above fn.174, 294.

receive a fixed capital return.³²⁴ Australian law differentiates more finely and places great significance on the question of whether the invested capital itself is always repaid (subject to insolvency) or whether there is a level of risk in the form of a participation in losses.³²⁵ However, it is possible for a capital investor to participate in losses with no logical connection to the question of whether he may set-off profits from the company against his own losses from other sources. The participation in losses can at best play a role when the question is asked whether each loss in value of the capital investment can be set-off against positive revenue from other sources or is “locked in” at the level of the company. There are special provisions in this regard, for example, under German law.³²⁶

On the other hand, it may be central to the question of the ability to set-off capital earnings against losses from other sources whether and to what extent the company on the one hand or the capital investor on the other hand can decide how the revenue is to be assigned. The synthetic concept of income is based on the assumption that the totality of revenue from various sources comprises the “available” income of the taxpayer. Thus, from this point of view, the company should be allocated those components of income where the company’s organs can decide whether they should be retained or distributed. If the company is allocated all revenue of this type, then the possibility of shifting revenue to the shareholders through the payment of returns on capital depending on the economic year must be taken away. On the other hand, it makes sense to allocate those components of income to the shareholder as his own income from the outset where he has the power to make the company pay. Because he has “command” of each of these income components, it is appropriate that he can set off the corresponding revenue with losses from other sources or financial years.

A particularly problematic situation arises when a national tax law provides for a personal tax exemption for revenue from capital earnings at the level of the recipient (for example, for public or not-for-profit facilities, pension funds, etc.). A personal tax exemption like this has the result that returns on equity at the level of the company are (fully) taxed once, whereas returns on debt are deducted at the level of the company and nevertheless not taxed at the level of the shareholder. This creates a significant preference for the debt financing of enterprises by providers who are personally tax-exempt.

This difficulty cannot be overcome by a clarification or modification of the dichotomy between equity and debt. The starting point is rather the teleology of the personal tax exemption as well as its effect on the financial and competitive situation for the enterprises involved.³²⁷ In this respect, the legislator must consider where to draw the line between exempt and non-exempt revenue at the level of the shareholder. One can imagine that profit-dependent revenue should be taxable in the hands of these taxpayers due to its “entrepreneurial” character, whereas fixed interest payments at the general market level are not relevant for tax purposes. In any case, this does not affect the actual distinction between debt and equity.

³²⁴ Compare CTA 2009 s.521C(2).

³²⁵ Woellner et al., above fn.224, Ch.22-015.

³²⁶ See EStG (Einkommensteuergesetz—Income Tax Act) §15 para.4 s.6–8 and KStG (Körperschaftsteuergesetz—Corporate Tax Act) §8b para.3 s.4–7.

³²⁷ R. Hüttemann, *Wirtschaftliche Betätigung und steuerliche Gemeinnützigkeit* (Cologne: Schmidt, 1991), 113 and following, 154 and following.

Equity and debt in international tax law

The three-pronged approach to international taxation of profits

From the point of view of the practice of international tax law, the fundamental difference between returns on equity and returns on debt is the fact that returns on equity are in principle subject to tax in the state of source of the entrepreneurial activity whereas returns on debt are in principle caught in the state of residence of the capital investor.³²⁸ The consequences can be seen not only in the different attribution of the taxing rights to the states involved, but also in the comprehensive tax planning possibilities for the investor and the recipient of capital.³²⁹ With regard to international taxation of outflowing profits the most explicit technique to allocate taxing rights to the source country lies in the introduction of a withholding tax. But it is predominantly when the recipients (for example, financing companies in the company group) are resident in states with an extremely low tax level³³⁰ that withholding taxes really become the critical tax factor. When one looks more closely it can be seen that source states, against the background of the domestic taxation of individual and corporate income that has been illustrated, can access the earnings from capital investments in three ways.

1. First, source taxation can ensue if the capital investor draws revenue from a permanent establishment in the source state and the state in which the permanent establishment is situated has the taxation right in accordance with Articles 5 and 7 OECD Model. Revenue that the taxpayer generates as a partner in a commercial partnership also falls under the taxation of permanent establishments. Here, the differentiation between an equity-like share in the business and debt-like capital participations³³¹ that has already been described comes into effect: revenue generated in a permanent establishment is directly attributed to the partners who jointly carry on the business: this is true for a general partner, a limited partner or any other person who, according to the underlying domestic tax laws, qualifies as a “partner” in a permanent establishment. For these taxpayers, there is a limited taxation liability for this commercial revenue in the state of source.
2. Secondly, the revenue of the capital investor, which is derived from a corporation resident in the source state, may be subject to corporate tax under domestic tax law before it is distributed by the corporation. Corporate tax is thus a fundamental “withholding tax” on (equity) earnings within a corporation.³³² If and to the extent that domestic corporate tax law designates certain financial instruments as equity

³²⁸ See in this regard E. Eberhartinger and M. Six, “Taxation of Cross-Border Hybrid Finance: A Legal Analysis” [2009] *Intertax* 4, 9.

³²⁹ R. Zielke, “Shareholder Debt Financing and Double Taxation in the OECD: An Empirical Survey with Recommendations for the Further Development of the OECD Model and International Tax Planning” [2010] *Intertax* 62.

³³⁰ E.D. Kleinbard, “Stateless Income” (2011) 11 *Florida Tax Review* 699, 728 and following; E.D. Kleinbard, “The Lessons of Stateless Income” (2011) 65 *Tax Law Review* 99, 140 and following.

³³¹ Above at p.179, “The principal tax consequences of the classification of capital”.

³³² *The Mirrlees Review*, above fn.6, 433 and following.

and thus does not allow a deduction for the returns payable on those instruments, taxation in the state of source occurs.

3. Thirdly, the possibility exists for the state of source to levy a withholding tax on out-flowing returns on capital in the hands of the foreign recipient. This possibility is in practice not only used for dividends but also often extends to certain returns on debt that are deductible when determining the corporation's profits.

The fact that there are three ways in which a source state can fiscally access capital returns flowing to taxpayers in foreign countries demonstrates that no uniform criteria are applied here in practice. Rather, domestic tax laws use various demarcation criteria to draw the line between equity and debt within the state and to draw the line for international tax purposes between returns that are subject to a substantial withholding tax and those that are subject to a lower or no withholding tax.

Capturing returns on debt in the state of source

According to domestic tax law, debt is characterised by the fact that neither a (business partner-like) participation in a joint commercial enterprise nor a shareholding in a corporation is established. The state of source can thus only set about capturing returns on debt in two ways:

1. First, the state of source can levy a withholding tax on returns on debt. One such withholding tax applies for example to out-flowing interest in Article 11 OECD Model; if the level of such a withholding tax corresponds to the total tax liability for returns paid out on equity due to corporate tax and capital yields tax, then it is even possible for a certain international neutrality for equity and debt finance to be established.³³³ However, the tax-policy approach to such withholding taxes on interest is globally quite varied. Developing and emerging countries currently endeavour to subject domestically generated earnings to substantial taxation by means of withholding taxes.³³⁴ In contrast, over the last few decades, large western industrialised countries have moved further and further away from levying withholding taxes on out-flowing interest and have either unilaterally anchored this in domestic tax law (e.g. Germany,³³⁵ UK,³³⁶ US,³³⁷ France³³⁸) or at any rate relinquished the levying of such withholding taxes in double tax treaties.³³⁹ Conversely, withholding taxes on dividends have continued to survive to a

³³³ Even with identical tax rates, certain differences remain that primarily affect the deduction of refinancing expenses on the one hand and the ability to claim expenses in the state of residence on the other.

³³⁴ O.H. Jacobs, *Internationale Unternehmensbesteuerung—Deutsche Investitionen im Ausland—Ausländische Investitionen im Inland*, 6th edn (Munich: Beck, 2007), 68 and following.

³³⁵ Compare EStG (Einkommensteuergesetz—German Income Tax Act) §49 para.1 No.5 letter c).

³³⁶ ITA s.875 and following.

³³⁷ Internal Revenue Code ss.871(h), 881(c) (*portfolio interest exemption*).

³³⁸ See B. Gouthière, *Les impôts dans les affaires internationales*, 9th edn (Levallois: Éd. Francis Lefebvre, 2012), para.62512.

³³⁹ Kees van Raad (ed.), *Materials on International & EC Tax Law 2013/2014* (Leiden: 2013), book jacket.

significant extent—in any case for payments on portfolio shareholdings,³⁴⁰ so that the total tax burden on out-flowing returns on equity is (almost) always significantly higher than the total tax burden on out-flowing returns on debt.

2. The waiver of source taxation on out-flowing interest cements the differentiation between equity and debt for international tax purposes. This effect is even greater if—as in the EU—the right of the debtor state to levy withholding tax is limited or ruled out by directives. This applies on the one hand to the Interest and Royalties Directive of 2003, which categorically rules out the levying of withholding taxes on interest payments within a group of companies.³⁴¹ It also applies to the Directive about interest on private savings: here a withholding tax is actually contemplated, but a significant proportion of the revenue from it is to be forwarded to the state of residence so that the higher-ranking taxation right of the state of residence is ultimately codified anew.³⁴²
3. If there is no legal basis for the levy of withholding tax on out-flowing interest or if the state of source has, in a double tax treaty or another international legal instrument, committed itself to waive such a withholding tax, then a second option for a “withholding tax” on returns on debt is to limit deductions for operating costs at the level of the recipient of the capital or to re-classify these payments as profit distributions. Traditionally, the rules about shareholder loans head in this direction, as they rule out deductions for returns on debt for shareholder loans if and to the extent that the stake held by the creditor exceeds a certain threshold and if and to the extent that the debt granted exceeds a statutorily-fixed relationship to the equity granted.
4. Recently, these special rules about shareholder loans have in many cases been replaced by the rules about the “interest barrier” and other *debt caps*, which, independently of the identity of the creditor,³⁴³ limit the deductions for returns on debt based on key balance sheet figures.³⁴⁴ This should on the one hand avert the untaxed flow of interest from subsidiaries dependent on the company group to foreign countries (*inbound* situation); and on the other hand avoid a situation where deductions are claimed for interest payments at the level of the parent company when they are in fact connected with investments that are taxable in foreign countries.³⁴⁵ Once again, European law has played a fundamental role here: because the Court of Justice of the European Union (CJEU) on the one hand held that special rules for shareholder loans could not be confined to foreign shareholders

³⁴⁰The UK is an exception in the sense that, with regard to dividends flowing to foreign countries, it unilaterally waives the levying of withholding tax, cf. J. Schwarz, *Schwarz on Tax Treaties*, 3rd edn (Kingston upon Thames: CCH, 2013), para.18-100 and Harris, above fn.16, 235, 355.

³⁴¹Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States [2003] OJ L157/49.

³⁴²Directive 2003/48/EC of 3 June 2003 on the taxation of interest payments [2003] OJ L157/38.

³⁴³See EStG (German Income Tax Act) §4h; similar approaches have been adopted in Italy and Spain.

³⁴⁴Brown, above fn.10, 35 and following.

³⁴⁵P. Hinny, “New tendencies in tax treatment of cross-border interest of corporations” (2008) 93b *Cahiers de droit fiscal international* 21.

and because it on the other hand required deductions for interest for the acquisition of subsidiaries to be formulated independently of the residence of the subsidiary, a far-reaching version of the limitations on the deductibility of interest was practically enforced.³⁴⁶

Both approaches—the levying of withholding tax on out-flowing interest, chargeable to the capital investor, as well as the limitation on the deductibility of interest when assessing the profits of the recipient of the capital—are designed, from a tax policy point of view, to minimise the economic (domestic) difference in the tax burden between earnings from equity and from debt. However, even here it remains necessary to legally distinguish returns on equity from returns on debt. For the very reason that withholding tax on out-flowing interest should be higher than capital yields tax on out-flowing dividends (in order to account for the dividends' prior corporate tax liability), the payment must be more precisely classified in accordance with its legal basis and the corresponding classification must as a rule be taken up at the level of the company making the payment. The levying of withholding tax is thus not designed to level out the legal difference between the forms of finance.

Further economically significant effects appear on the part of the state of residence. It makes a significant difference to the scope of taxable income and the extent to which foreign taxes are taken into account whether the prior tax burden in the state of source is imposed at the level of the paying corporation (corporate tax) or at the level of the recipient capital investor (withholding tax). A true double taxation of earnings on debt is pre-programmed in particular if deductions are not allowed for returns on debt at the level of the company. The classic distinction between equity and debt in international tax law will therefore not become obsolete due to these new developments; rather, its consequences will be intensified.

Comparative source taxation for returns on capital

The international tax competition for mobile capital has influenced the withholding tax policy of states all over the world for decades. The waiver of, or the very restrained levying of, withholding taxes on out-flowing interest thus belongs to the repertoire of not only double tax treaties but also of unilateral legislation in many states.³⁴⁷ The rules regarding the limited taxation of interest in Germany,³⁴⁸ in Switzerland,³⁴⁹ in the US as well as in the UK³⁵⁰ are a good example of a far-reaching one-sided relinquishment of the levying of withholding taxes on interest. France has most recently, in 2010, fundamentally done away with withholding taxes on out-flowing

³⁴⁶ As a reaction to the ECJ judgments *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (C-324/00) [2002] ECR I-11799; [2003] STC 607 and *Bosal Holding BV v Staatssecretaris van Financiën* (C-168/01) (*Bosal*) [2003] ECR I-9409; [2003] STC 1483 Germany, the UK and the Netherlands extended the scope of their thin capitalization regimes to purely domestic transactions.

³⁴⁷ Global Legal Group (ed.), *The International Comparative Legal Guide to: Corporate Tax 2012—A practical insight to cross-border Corporate Tax work* (London: 2011).

³⁴⁸ Compare EStG (Einkommensteuergesetz—German Income Tax Act) §49 No.5 letter c).

³⁴⁹ Only for certain types of interest, see Bundesgesetz über die Verrechnungssteuer Art.4 para.1 lit.a et d.

³⁵⁰ ITA s.875 and following.

interest.³⁵¹ In newer provisions, however, a higher withholding tax is in part levied on interest flowing to certain “tax havens” (France³⁵²).

In contrast, in developing and emerging countries a financial burden is often thrust upon out-flowing interest.³⁵³ Brazil is an important example, where a withholding tax of 15 per cent is levied on interest.³⁵⁴

A similar relief effect is achieved by countries that include a limited tax liability for outflowing interest in their domestic tax law but to a great extent step away from this in their double tax treaties. Of the examined countries, Greece belongs to this group.³⁵⁵ Brazil, in contrast, insists—like many other developing and emerging countries—on a substantial withholding tax on out-flowing interest.³⁵⁶

In so far as countries levy a withholding tax on out-flowing interest both under their domestic law and under their double tax treaties, it must finally be taken into account that withholding taxes on out-flowing interest³⁵⁷ as a rule apply a significantly lower tax rate when compared to the liability for out-flowing earnings on equity. Thus, paragraph 2 of Article 11 OECD Model suggests a withholding tax rate of 10 per cent, while portfolio dividends are supposed to be subject to 15 per cent in addition to the prior corporate tax liability in the state of source at the level of the company. This corresponds to the practice in most countries.³⁵⁸ Even if the state of source does not apply nil taxation to interest, the difference between equity and debt is noticeable in the significantly lower effective taxation.

Finally, the EU Savings Directive is a special rule for private interest on savings in the EU. As a starting point, it emphasises the taxation right of the state of residence and obliges the other countries to automatically exchange information regarding interest earnings. For the time being, it allows some states to levy a withholding tax on interest instead of engaging in cross-border information exchange. This withholding tax is, however, subsequently (after deduction of a small remuneration) forwarded to the state of residence. In this way, the Savings Directive confirms the priority of the state of residence’s taxation right on two counts.³⁵⁹

Of particular interest for our inquiry is the question whether and in which way the examined countries endeavour to capture the cross-border taxation of earnings from hybrid debt holdings in conformity with the system. Three methods are considered:

1. the subsumption within (or the same treatment as) interest;
2. the subsumption within (or the same treatment as) dividends;
3. the separate capture as an independent object of taxation.

³⁵¹ Gouthière, above fn.338.

³⁵² Code Général des Impôts Art.125 A (III), (III bis)(11).

³⁵³ Global Legal Group, above fn.347, 63, 64, 120, 121.

³⁵⁴ Normative Instruction of the Brazilian Federal Tax Authority (Instrução Normativa da Receita Federal do Brasil—IN RFB) No.1022/10 Art.68 II and Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) Art.702.

³⁵⁵ N. 52/1967, Art.VII(1), N. 3724/2008 Art.11(2), N.D. 2548/1953.

³⁵⁶ Normative Instruction of the Brazilian Federal Tax Authority (Instrução Normativa da Receita Federal do Brasil—IN RFB) No.1022/10 Art.68 II Decree No.3000/99 (DOU March 29, 1999; DOU June 17, 1999) and Art.702.

³⁵⁷ Global Legal Group, above fn.347, 63, 64, 120, 121.

³⁵⁸ An unusual feature can be found in some Greek conventions, which contain very comprehensive withholding taxes on out-flowing dividends—probably in consideration of the earlier application of the dividend deduction method.

³⁵⁹ This tendency is confirmed by the (not yet ratified) convention between Germany and Switzerland regarding the taxation of capital returns.

The starting point for this analysis in the examined countries is the assumption that the earnings from hybrid debt holdings, just like returns on simple loans, are to be classified as “interest” and treated as such under domestic tax law and the applicable double tax agreements. This is also fundamentally true of profit-dependent remuneration for debt (in so far as a deduction for this is not—as in the UK³⁶⁰—already ruled out at the level of the recipient of the capital). Accordingly, in terms of the demarcation between Article 10 OECD Model (dividends) and Article 11 OECD Model (interest), it is assumed at the outset that profit-dependent returns on debt are fundamentally to be subsumed within Article 11 OECD Model.³⁶¹ The right to participate in profits does not, under paragraph 2 of Article 10 OECD Model, explicitly rule out a subsumption of the earnings within the interest article. Against this background, for example, from the perspective of France³⁶² (exception DTA France/US³⁶³) and Switzerland³⁶⁴ (exception DTA Switzerland/Germany³⁶⁵) profit-dependent returns on loans are treated like interest and (in any case partially) exempted from domestic withholding tax in the double tax agreements. In this respect one must note that in France, a participation in losses by the capital investor together with certain control rights automatically leads to a classification as a silent partnership and thus to the application of corporate tax law.

However, some countries have made use of the opportunity to impose a withholding tax on profit-dependent remuneration in a manner that conforms with the system despite its classification as a return on debt and have also included this in their double tax agreements. A good example is the US, which captures profit-dependent payments to foreign capital investors on a doubled basis. Domestic law directs that *contingent interest* (which is widely defined and can also include turnover-dependent or other success-dependent payments) is subject to withholding tax: this right is ensured in many DTAs through an extension of the right to levy a withholding tax on interest. The UK directs that profit-dependent payments are not deductible as operating costs anyway. But the consistency of this rule with the double tax agreements is highly contested.³⁶⁶

Finally, even for fixed-interest bearing loans, withholding taxes outside a country’s usual practice come under consideration in special cases. Thus, from the US point of view, interest on “perpetual bonds” is also subject to withholding tax. In the UK deductibility is denied for interest payments on “equity notes” (term of more than 50 years) to associated enterprises in foreign countries.³⁶⁷ In Germany—in accordance with complicated provisions—a limited tax liability is

³⁶⁰ CTA 2010 ss.1000(1)F, 1015(4).

³⁶¹ J.F. Avery Jones et al., “The Definition of Dividends and Interest in the OECD Model: Something Lost in Translation?” (2009) 1 *World Tax Journal* 5.

³⁶² Osterloh-Konrad and Lagdali, above fn.181, 426.

³⁶³ DTA France/US Arts 10(5)(a), 11(2).

³⁶⁴ Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.a, Art.20 para.29; Reich, above fn.242; Tischbirek in K. Vogel and M. Lehner (eds), *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen—Kommentar*, 5th edn (Munich: Beck, 2008), Art.10 para.234; P. Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz* (Zurich: Schulthess Jurist. Medien, 2012), 289.

³⁶⁵ DTA Switzerland/Germany Art.10 para.4.

³⁶⁶ Compare Schwarz, above fn.340, para.18-150.

³⁶⁷ CTA 2010 ss.1000(1)F, 1015(6), 1032(1). See also Harris, above fn.16, 195.

imposed on interest on certain convertible bonds,³⁶⁸ which is, however, retracted in most double tax agreements.³⁶⁹

The simple subordination of claims in case of insolvency has no significance for the application of domestic and international rules regarding the allocation of taxing rights.³⁷⁰

Some states have resolved to not only allow for the taxation of profit-dependent debt remuneration in their domestic international tax law but to include this taxation right at the same time in their double tax agreements through an extension of the concept of dividends to profit-dependent earnings.³⁷¹ Thus, in many German treaties, earnings from silent partnerships, participating loans and income bonds are (as distinct from normal interest earnings) subject to the limited domestic tax liability and treated like dividends in the double tax agreements.³⁷² Older German agreements still draw a dividing line between participating loans (interest) and silent participations (dividends). The US still uses this practice in its agreement with the Netherlands.³⁷³

Often the concept of dividends also applies to “debt-like participation rights”, which are in fact treated under domestic law as debt for tax purposes, but whose earnings, considering their profit-dependence, are subject not only to a limited tax liability but are also classified as “dividends” in double tax agreements.

In France³⁷⁴ and Greece³⁷⁵ this problem does not arise because the profit shares of silent partners are subject to domestic corporate tax law in any case and thus the distributions are also classified as dividends.

If one looks more closely, the subsumption of profit-dependent returns on debt within “dividends” proves itself to be systemically flawed. Dividends distinguish themselves from all returns on debt in so far as they are paid out of corporate profits taxed under the corporate income tax. Accordingly, in consideration of this substantive liability, the state of source waives a withholding tax for earnings from inter-company holdings (and taxation in the state of residence of the capital investor is also often waived). In doing so, the borderline between portfolio shares and inter-company holdings is regularly drawn according to the voting rights in the corporation (which does not work for profit-dependent debt holdings).

Against this background, the systematically correct way to impose withholding tax on profit-dependent debt holdings is to establish an unlimited taxation right—in the way that permanent establishments of partnerships are taxed. Some double tax agreements are in fact going down this path, for example, the DTAs concluded by Austria for silent participations and participating loans³⁷⁶ or some of the agreements concluded by the US.³⁷⁷ Paragraph 6 of Article

³⁶⁸ Compare EStG (Einkommensteuergesetz—German Income Tax Act) §49 No.5 letter a).

³⁶⁹ F. Wassermeyer in F. Wassermeyer, *Doppelbesteuerung* (Munich: Beck, 2013, EL 124), Art.11 OECD Model note 10.

³⁷⁰ M. Lang, *Hybride Finanzierungen im Internationalen Steuerrecht* (Vienna: Orac, 1991), 150 and following.

³⁷¹ H. Pijl, *Interest from Hybrid Debts in Tax Treaties* (Amsterdam: IBFD, 2011), 482, 495—Netherlands. For another example see DTA US/France Art.10(5)(a).

³⁷² Wassermeyer, above fn.369.

³⁷³ DTA US/Netherlands Art.10(6)2. The Netherlands’ Model Agreement expands the definition of dividends to all loans with a participation in profits. See Pijl, above fn.371.

³⁷⁴ Code Général des Impôts Art.206(4).

³⁷⁵ KFE (Kodikas Forologias Eisodimatos—Income Tax Act) Arts 10(1), 28(4b), N. 52/1967 Art.II.

³⁷⁶ However Austria does not exercise its domestic taxation right for revenue from participating loans.

³⁷⁷ e.g. DTA US/Austria Art.10(3) subclause 2.

10 of the US/Germany DTA is paradigmatic, it provides an unlimited taxation right for the state of source for all profit-dependent remuneration that is deductible for the recipient of the capital.³⁷⁸ To date, this path has been only seldom trodden internationally.³⁷⁹

In the Germany/Switzerland³⁸⁰ DTA a similar method has been found through a blanket increase in the withholding tax entitlement to 30 per cent (compared to 5 per cent and 15 per cent for “real” dividends from portfolio and inter-company holdings respectively).³⁸¹

In the international tax law of the examined countries, hybrid equity holdings are treated in principle like normal equity holdings. This is above all true for those financial instruments that embody a corporate law membership and diverge from it only in isolated points. Thus, earnings from preference shares—and *redeemable shares* or holdings that strongly resemble debt—are, according to domestic and international tax law, dividends. This is also true in Switzerland of participation shares.³⁸² In France, the proposal to make debt-like *actions de préférence* subject to the rules applying to debt has not been taken up to date.³⁸³

The legal situation for contractual holdings that are treated in the same way as equity by domestic tax law is not so clear. Typically, these lack classification as a “participation” for the application of paragraph 3 of Article 10 OECD Model. In contrast, the US Model Convention does not expressly look to the “participation character” of a financial instrument (like the OECD Model) to classify payments as dividends; rather all payments that are made in respect of “equity holdings” for tax purposes under domestic law can be made subject to withholding tax, like dividends. However, in the US/Austria³⁸⁴ DTA this is expressly limited to “other corporate rights” (in the manner of a silent partnership). In the US/Switzerland DTA, this point is inclusively or exclusively resolved depending on the language version and a compromise has been reached in an additional protocol.³⁸⁵³⁸⁶

Debt-like participation rights and foundation bonds provide further examples. Thus for “debt-like” participation rights a special provision is often inserted in the DTA in order to treat these like dividends or to capture them otherwise in the state of source.

In Brazil earnings from participation certificates, which do not represent a capital contribution but simply a profit participation, are treated like dividends.³⁸⁷

³⁷⁸ Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between The United States and Germany (JCX-47-07)* (July 13, 2007), 43.

³⁷⁹ Tischbirek, above fn.364, Art.10 notes 231 and 234.

³⁸⁰ DTA Switzerland/Germany Art.10 para.2 lit.b.

³⁸¹ Compare DTA US/Switzerland Art.11(6)(a); Technical Explanation US/Switzerland Art.11(6); Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Swiss Confederation (JCS-16-97)* (October 6, 1997), 26.

³⁸² Bundesgesetz über die direkte Bundessteuer Art.20 para.1 lit.c s.1; Locher, above fn.241; Bundesgesetz über die Verrechnungssteuer Art.4 para.1 lit.b; Tischbirek, above fn.364, Art.10 para.198; Hongler, above fn.364, 285.

³⁸³ H. Le Nabasque, “La réforme des actions de préférence” [2008] 48 *La Semaine Juridique—Entreprise et Affaires* 38, 39.

³⁸⁴ See B. Gröhs in Gröhs et al. (eds), *Kurzkommentar zum neuen Doppelbesteuerungsabkommen Österreich—USA* (Vienna: Linde, 1997), Art.10 m.no.11.

³⁸⁵ DTA US/Switzerland Art.10(4); DTA US/Switzerland, Protocol, No.4.

³⁸⁶ DTA US/Switzerland, Protocol, No.4.

³⁸⁷ M.O. Castelon, “Eigen- und Fremdkapital im Steuer- und Gesellschaftsrecht Brasiliens” in Schön, above fn.14, 195, 281.

A new approach to debt and equity in international taxation

From the point of view of international tax jurisdiction it cannot be disputed—in accordance with the general principles of international tax law—that returns on debt, just like returns on equity, are generated in the state of source and thus there is no doubt that, in accordance with the principle of “economic allegiance”, the “Debtor State” is entitled to introduce a source tax on return on debt just like on return on equity.³⁸⁸

Nevertheless, a tax policy analysis and appraisal of the international taxation of returns on capital must start with the fact that in past and present international tax practice the state of source levies a clearly higher tax burden on returns on equity than on returns on debt. Of particular significance is the fact that returns on equity for corporations are not only subject to the prior corporate tax liability but a substantive withholding tax is also frequently provided for, whereas interest is on the one hand deductible for the debtor and on the other hand subject to no or low withholding tax.³⁸⁹

The first key point that plays a serious role here is tax competition and its effects on the exercise of international taxation rights.³⁹⁰ Tax competition has the result that countries are prompted to waive given taxation rights to promote domestic economic activity, particularly capital investments. This can be clearly seen in the taxation of interest. The fact that countries unilaterally or bilaterally waive the levying of any substantive withholding tax on out-flowing interest is fundamentally due to the interests of the state of source in not confronting its domestic (private or public) debtor with the possibility of the creditor “grossing up” the additional tax burden (in so far as this cannot be deducted in the state of residence) to the required interest payments. This market power of creditors is attributable to the high mobility of financial capital and the many and various investment alternatives in other countries.³⁹¹ Given that creditors only rarely have a clear preference for a certain debtor on the market for sovereign and corporate bonds and thus can easily divert their monetary investments to other jurisdictions, a lowering of the taxation of interest in the state of source has occurred over several decades. In Germany this situation has been consistently anchored in law since the Weimar Republic,³⁹² in the UK since the development of the Eurobond market in the 1970’s, in the US since the Reagan Administration’s tax reforms

³⁸⁸ A. Schindel and A. Atchabahian, “Source and residence: new configuration of their principles” (2005) 90a *Cahiers de droit fiscal international* 21, 50 and following.

³⁸⁹ Eberhartinger and Six, above fn.328.

³⁹⁰ W. Schön, “International Tax Coordination for a Second-Best World, Part 2” (2010) 2 *World Tax Journal* 65, 74 and following.

³⁹¹ H. Huizinga, “The incidence of interest withholding taxes: Evidence from the LDC loan market” (1996) 59 *Journal of Public Economics* 435.

³⁹² Compare Regulation of October 16, 1930 on the Abolition of Withholding Taxes and Limited Tax Liability on Fixed Interest Notes (Verordnung über die Aufhebung des Steuerabzugs vom Kapitalertrag und der beschränkten Steuerpflicht bei festverzinslichen Wertpapieren) §2 letter b), RGBl. I 1930, 465, amending §3 para.2 No.9 EStG 1925 (Einkommensteuergesetz—Income Tax Act 1925).

of the 1980s.³⁹³ In contrast, developing and emerging countries have tried to resist this trend in recent years and to enforce substantial withholding taxes on interest.³⁹⁴

For finance by means of equity holdings, the hypothesis has also been widespread in economic literature since the 1980s that the tax burden of the corporate tax and other taxes would tend to decrease with the increasing tax competition. This has indeed proved itself to be true with the setting of corporate tax rates. However, corporate tax rates have never reached the low level of withholding taxation on out-flowing interest.³⁹⁵ Even more astonishing is the fact that in spite of the tax competition and in spite of their underlying liability for corporate tax, portfolio dividends flowing to non-residents are still subject to significant withholding taxation and that the tax rate for this withholding tax is usually higher than the withholding tax rate for out-flowing interest.³⁹⁶

This persistent difference in the tax burden in the state of source can be primarily explained by the different effects brought about by the mechanics of tax competition for equity holdings and debt holdings respectively. This begins with the domestic corporate tax in its function as a withholding tax on the capital income of foreign investors. Here it must first of all be noted that it would be extraordinarily difficult, from a technical point of view, for the regulatory system to differentiate between “normal” corporate tax as “pre-paid income tax” on the domestic participations of domestic investors on the one hand and the corporate tax as a territorial source taxation for foreign investors on the other hand.³⁹⁷ Corporate tax always captures all corporations and does not draw distinctions on the basis of the residence of the shareholding entity. Further, it does not make sense for the corporate tax to differentiate on the basis of the individual mobility of the enterprise. Rather, this tax must be uniformly levied, independent of whether new or old investments are concerned, of how the enterprise has been set up or arranged, and of the personal “elasticity” of the shareholders.

In contrast, it is easier to yield to international competition for the taxation of interest. Returns on debt are deductible anyway at the level of the enterprise; source taxation can thus only appear within the framework of a withholding tax specifically aimed at the taxation of foreign investors. Thus a simple reduction or abolition of withholding tax will increase the attractiveness of the investment for the foreign (debt) investor.

In addition, the fact is that returns on equity clearly differ from returns on debt in their risk profile and volatility as well as in the possibility of generating economic rents. Whereas the usual return on debt depends on no other substantial parameter than the average market interest rate, the prospects of the underlying currency and the risk of insolvency of the debtor concerned, returns on equity depend on the economic prospects of success of the company involved, its geographical situation, the quality of the products, the domestic and international customer markets and further specifics. This means that the investment of equity in a certain enterprise

³⁹³ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (JCS-41-84)* (December 31, 1984), 392.

³⁹⁴ Global Legal Group, above fn.347, 63, 64, 120, 121; C. Clarke and P. Vianna, “New tendencies in tax treatment of cross-border interest of corporations, Country Report Brazil” (2008) 93b *Cahiers de droit fiscal international* 151, 164.

³⁹⁵ Auerbach, Devereux and Simpson, above fn.6, 837, 846 and following.

³⁹⁶ Vann, above fn.222, 45 and following.

³⁹⁷ J.G. Gravelle, “The Corporate Income Tax: A Persistent Policy Challenge” (2011) 11 *Florida Tax Review* 75, 91 and following.

cannot easily be replaced by an investment in a different enterprise in a different state of source. He who acquires shares in a German or US American chemical enterprise in the hope of inframarginal returns or increases in value from this investment will justify this decision with the particular qualities of this particular investment. It is only if the goal in acquiring shares is simply to achieve a regular market return within the framework of a diversified portfolio strategy that diverse investments in diverse countries prove themselves to be exchangeable.

Against this background it becomes apparent why the source states have succeeded in continuing to levy a substantial source taxation on profits from equity holdings in the form of corporate tax as well as (in comparison to interest, increased) withholding tax on out-flowing dividends. The shareholder in a specific corporation simply does not have the possibility of acquiring exactly the same kind of investment in another jurisdiction and is thus less able to benefit from the pressure of tax competition.

That means, in turn, that the demarcation between those investments that—like interest—should be subject to a lower or no withholding taxation and those investments that—like dividends—can be subject to both a corporate tax as well as a withholding tax, should be determined by the specifics of the investment and thus the effects of international tax competition on the investment decision. The following features lend themselves to this:

1. All profit-dependent capital holdings are enterprise-specific; the resulting earnings can and should thus be captured by local source taxation. To do so it is either possible to classify these profit shares as income from a permanent establishment subject to a limited tax liability or to subject them to an increased withholding tax as dividends or to capture them as a tax category of its own. The goal should be that the total tax liability of profit-dependent capital holdings in the state of source—taking together the level of the corporation (deductible or not) and the level of the shareholder (withholding tax)—is approximately the same. In this way a consistent tax liability in the state of source for profit-dependent payments in respect of debt and equity holdings is procured.
2. Other capital holdings should only be captured by local source taxation if the return is specifically associated with the enterprise receiving the capital in the state of investment in other ways. That can be the case for high interest bonds if and to the extent that they include a special capital return by reason of the special operating risks of the debtor-enterprise. That can also be envisaged for “perpetual” bonds where the creditor is not able, within the framework of tax competition, to unilaterally reallocate his funds to other jurisdictions. In each of these cases the investments involved are those that are not “mobile” in the sense that the object of the investment is exchangeable at will and therefore less amenable to tax competition constraints.

Shareholder loans, above all intra-group loans, are a specific case of the last-described type of debt holdings, whose allocation is not subject to the general rules of tax competition. This capital is granted within company groups (particularly multi-national enterprises) without consideration for the open capital markets and their economic rationalities. Rather they are allocated in accordance with the specific capital requirements of each subdivision of the entire concern. It

is evident on the basis of the special information advantages within the group as well as the pursuit of synergies and the increase in the total group profit that results from its investments, that financial means are not simply granted to a subsidiary in the alternative to third party enterprises on the general market depending on the interest rate and risk of insolvency. Rather, when a parent company makes a decision to grant a group company credit, it does not only consider the expected interest and the security of repayment but simultaneously considers the expected return flows from its equity investment in this enterprise. This means that committing to a shareholder loan is, from an economic viewpoint, the same as committing to an investment of equity. It can be concluded from this that the mechanics of international tax competition for open-market corporate bonds cannot claim applicability in this area. Against this background, it is not acceptable that corporate groups have the ability to influence the allocation of profits for tax purposes by choosing between debt and equity finance from subsidiaries.³⁹⁸

The consequence of this is that shareholder loans—as distinct from normal third party loans—can and must be subject to a substantial withholding tax in international tax law in order to achieve the same treatment as “real” equity. The legal problem is, however, that the levying of this withholding tax is to a great extent barred: within European law, the Interest and Royalties Directive of 2003 specifically bans the levying of withholding tax on interest payments within company groups. Within double taxation law, neither the interest nor the dividends article of the OECD Model or the UN Model provides for a substantial withholding tax for shareholder loans; rather these are in principle subject to the generic article on interest; a re-classification of interest payments within a company group as dividends would only be endorsed in exceptional cases (which would even then only lead to the application of the withholding tax contemplated for dividends).³⁹⁹

Against this background, the legislative technique of the “deduction limitation” has developed over recent years, which, at the level of the interest-paying corporation, either prohibits a deduction only for interest from shareholder loans or for interest from loans in general above a certain key amount.⁴⁰⁰ From a technical regulatory point of view this is highly problematic because, on the one hand, a fictional and thus non-available profit is taxed at the level of the interest-paying corporation; on the other hand, no tax credit is given at the level of the recipient of the payment for the prior liability in the state of source in order to prevent economic double taxation. The (declining⁴⁰¹) technique of “re-classifying” debt earnings as equity earnings is to be recommended in preference, as this at least ensures that the rules about dividends are applied to the out-flowing payments from the point of view of the state of source.⁴⁰² A corresponding application in the state

³⁹⁸ H. Huizinga, L. Laeven and G. Nicodème, *Capital Structure and International Debt-Shifting*, IMF Working Paper WP/07/39 (2007); T. Buettner, M. Overesch and G. Wamser, “Tax Status and Tax Response Heterogeneity of Multinationals’ Debt Finance” (2011) 67 *Public Finance Analysis* 103 and following; M. Ruf, “Why is the Response of Multinationals’ Capital Structure Choice to Tax Incentives That Low? Some Possible Explanations” (2011) 67 *Public Finance Analysis* 123.

³⁹⁹ Avery Jones et al., above fn.361, 34 and following.

⁴⁰⁰ Hinny, above fn.345, 15 and following; Brown, above fn.10, 35 and following.

⁴⁰¹ W. Kessler and D. Knörzer, “The Implications of the (Reverse) Ban on Interest” (2008) 50 *Tax Notes International* 427.

⁴⁰² Regarding the consistency of these rules with the Interest and Royalties Directive see T.J.C. Van Dongen, “Thin Capitalization Legislation” (2012) 52 *European Taxation* 20.

of the recipient (including a preparedness to make an allowance for capital yields tax and to take the corporate tax into account) is indeed not guaranteed but should be part of the system.

The fundamental question with respect to limitations on deductions and re-classifications is whether it is only returns on shareholder loans that should be subject to these legal consequences or whether as a further step, returns to third parties should also, to a certain extent, be equated with earnings from equity.⁴⁰³ From the point of view of the economic peculiarity of shareholder loans and their different effect in international tax competition there are fundamental reasons for a differentiation: interest payments to third parties are subject to the full pressure of tax competition, and therefore a contractual shifting of the additional liability from loan debtor to loan creditor is not an option. An equivalent treatment for third party loans and shareholder loans can only be considered if and to the extent that their economic substance is comparable. This is evident for *back-to-back* finance between enterprises in a company group via an external credit institution.

It can, however, be questionable if such a comparability also exists if it is merely the gearing level of the individual group companies with external creditors that varies.⁴⁰⁴ The profit and loss situation between the group companies can be “indirectly” influenced in this way. One must differentiate here: an equivalence with shareholder loans is to be assumed if the level of the individual indebtedness of a group company is higher than the entire indebtedness of the group (see the British *world-wide debt cap*⁴⁰⁵). This is due to the fact that in such a case it can be assumed that equity will be “converted” to debt through internal measures. The assumption made by German law is much stricter: a limitation on deductions applies to external loans if the ratio between equity and debt in a certain group company is higher than the ratio of equity to debt for the whole group.⁴⁰⁶ This requirement means that the taking up of additional debt on external markets by an individual enterprise in the company group will be subject to tax. There is in principle no reason for this from the point of view of a principle-guided taxation of revenue from interest and dividends.

Important for the preservation of an adequate taxing right in the state of source is, however, not merely the introduction of “limited” source taxation or a limitation on deductions but above all the bilateral or multi-lateral agreement on the content of rules between the states involved. The present situation—the parallel existence of completely different provisions for shareholder debt finance, interest caps and the re-classification of payments—can in its totality lead to massive double taxation of interest on shareholder loans. Classification conflicts here can result in both *double non-taxation* and *double taxation*. A harmonisation of the criteria (possibly as part of the OECD Model Convention) would yield significant progress.⁴⁰⁷ It would at the same time weaken the options for unilaterally unfair competition.⁴⁰⁸

⁴⁰³ Kessler and Knörzer, above fn.401, 427 and following.

⁴⁰⁴ Marquart, “Steuerinduzierte Fremdfinanzierung von Unternehmen und Wege der Begrenzung des Zinsabzugs” in Schön, above fn.14, 125, 132 and following.

⁴⁰⁵ Taxation (International and Other Provisions) Act 2010 s.260 and following.

⁴⁰⁶ EStG (Einkommensteuergesetz—German Income Tax Act) §4h para.2 s.1 letter c).

⁴⁰⁷ Zielke, above fn.329, 85 and following.

⁴⁰⁸ V. Kalloe, “Corporate Tax Treatment of Interest: EU State Aid and the EU Code of Conduct as a Means of Combating Harmful Tax Competition” (2011) 51 *European Taxation* 504 and following.

The real difficulty does not lie in the issue of the “economic” comparability of “inbound” external credit with a shareholder loan. It lies in “outbound” cases when countries have to decide whether they only allow a part of the deductible interest burden for multi-national company groups to be incurred in their jurisdiction.⁴⁰⁹ This is meant to prevent parent companies from taking loans on external markets, forwarding these to foreign subsidiaries as equity and thus arriving at domestic deductions for interest while at the same time the profits falling to the subsidiary are taxed in its country of residence and the dividends ultimately paid out in the state of residence of the parent company are either completely exempt from tax or the taxation is deferred (and there is a foreign tax credit for the underlying foreign taxes). Countries have an interest to “nudge” company groups to take loans via the companies that will be subject to tax in respect of the corresponding returns. From the point of view of the Member States of the EU, such a rule is particularly urgently required because domestic legislatures are prevented, by several decisions of the CJEU regarding freedom of establishment, to simply prohibit a deduction for costs in connection with shareholdings in foreign subsidiaries.⁴¹⁰ On the other hand, it is necessary to prevent a situation where interest expenses, which economically burden the group, cannot be deducted anywhere because currently there is no meaningful technique to allocate out-flowing interest payments which are subject to a “limitation of deduction” at the level of the parent company to the subsidiary due to the separation of the respective entities—parent and affiliate—under civil and tax law.⁴¹¹ A co-ordinated international effort leading to a harmonised allocation of interest among group members and jurisdictions should be the ultimate goal.

Conclusion

The above analysis shows that it is very difficult to abolish the distinction between equity and debt in the tax world. This is not only due to practical reasons but rather also to the outcome of a systematic analysis.

- Under individual income taxation, the distinction is necessary in order to draw a rational boundary in the context of partnerships and comparable cases of joint business ownership between persons internal and external to them. The technique of a joint assessment of the profits and their direct attribution to the participants is only required for the internal participants. For this outcome, the criterion of joint control of the capital deployed to generate revenue stands as the fundamental differentiating feature.
- A similar reasoning applies for corporate tax law: here the issue is the fundamental differentiation between deductible operating costs and non-deductible profit shares, which is necessary for every form of corporate taxation. This distinction between equity holders and debt holders should fundamentally take into account whether

⁴⁰⁹ M.J. Graetz, “A Multilateral Solution for the Income Tax Treatment of Interest Expenses” (2008) 62 *Bulletin for International Taxation* 486 and following.

⁴¹⁰ *Bosal* (C-168/01), above fn.346, [2003] STC 1483; *Finanzamt Offenbach am Main-Land v Keller Holding GmbH* (C-471/04) [2006] ECR I-2107; [2007] STC 962.

⁴¹¹ W. Schön, “Die Abzugsschranken des §3c EStG zwischen Verfassungs- und Europarecht” [2001] *FinanzRundschau* 381.

the company (or its organs) makes the decision about the distribution of profits or whether this decision lies in the hands of individual capital investors.

- Yet another differentiating factor seems appropriate in international tax law: because the pressure of tax competition functions differently for debt holdings and equity holdings, there are good arguments to suggest that source taxation should be extensively waived for debt holdings whereas for equity higher taxation in the state of investment can be enforced. Thus, alongside equity shares under corporate law, profit-participating loans or shareholder loans should also be subject to substantial source taxation in the state of investment.

An especially important goal lies in the endeavour to formulate nationally and internationally uniform criteria for these distinctions so as to ensure that no double taxation or double non-taxation arises in the interplay of the respective legal systems. This study attempts to contribute to this discussion by formulating manageable and generalisable benchmarks for the demarcation between debt and equity that can be applied in the tax practice transnationally. Against this background, the results of this study—the formulation of an internationally feasible demarcation between debt and equity instruments under individual income taxation, corporate income taxation and international income taxation—can also help to address the intricate problem of “hybrid mismatches” employed in the area of financial instruments. ¹³

¹³ Austria; Brazil; Comparative law; Contracts; Corporate finance; Equity; Financial instruments; France; Germany; Greece; International taxation; Netherlands; OECD; Partnerships; Switzerland; United States