The article analyses the tax classification and tax treatment of profit-participating loans (PPL) in international tax law. In order to analyse the tax aspects of PPL, the commercial and economic background is provided. Following this, a comparative overview of the tax law classifications in the United States and Germany and an in-depth analysis of the tax classification and treatment in Danish law are provided. Next, the article analyses whether payments under PPL fall under the scope of the EU corporate tax directives and also considers the income tax treaty protection of payments under PPL.

I. INTRODUCTION

Profit-participating loans (PPL) or participating debentures/bonds constitute hybrid financial instruments or more precisely hybrid debt instruments.1 Such instruments are well-known legal instruments in several countries under different names.2 English-speaking countries often use the terms: profit participation loans, participating debentures/bonds, or profit sharing bonds. German-speaking countries refer to the instruments as Gewinnschuldsverschreibungen, Gewinnobligationen, Partiarischen Darlehen, and sometimes also as Genusschein. In Sweden, the term vinstandelivis is applied, whereas the term ’udbyttegivende geldkredit’ is used in Danish law. In the following the term, ‘PPL’ is used to describe the range of debt instruments of a profit-participating nature. PPLs are often defined against jouissance rights (Genussrechte), which constitute a right to participate in a company’s profit without being debt.3

Even if PPLs are not internationally standardized financial instruments, an increase in the use hereof can be observed both regarding domestic and international issuances.4 PPLs are to a certain extent applied in international financing structures, but they are not commonly issued in public markets.5

From a Danish perspective, the unfortunate truth is that the legal status of PPLs, after more than thirty-five years following introduction of the company law legislation, cannot be said to be finally clarified for tax law purposes. PPLs have been found in Nordic business practice for quite some time.6 The Danish Public Companies Act from 1973 introduced specific legislation regarding profit sharing bonds issued by Danish limited liability companies.7

1 The authors have co-authored the article. However, Jakob Bundgaard is the sole author of the sections regarding US law, German law, EU law, and double tax treaties.


3 See, e.g., McCormick & Creamer, supra n. 2; Nils Mattsson, Aktiengesetze Finanzierungsgueter (Stockholm: Norstedt, 1977) and in TfR (1976), 198 et seq.

4 See B. Larking (ed.), IBFD International Tax Glossary, 5th edn (Amsterdam: IBFD, 2005), 242, and the commentary in para. 24 to Art. 10(3) of the OECD Model Convention. Such rights are used in German and Swiss law, notwithstanding that the terminology is not always clear and contains instruments allowing the holder all shareholder rights except from voting power of actual debt instruments. See K. Vogel, On Double Taxation Conventions, 3rd edn (The Netherlands: Kluwer Law International, 1997), 119, 655 f. (ma no. 193) and in DBA Dubbelbesteuerungsabkommen (2008), 922 (ma no. 193 et seq.). See from German case law regarding the distinction between dividends and interest on payments from Genusscheинrechte, according to a tax treaty, Decision of 11 Dec. 2003, Finanzgericht Köln, 2 K 7273/00. A prevailing freedom of contract applies regarding the form of ‘Genussrechte’ in Austrian law and therefore such instruments are related to other hybrid instruments; see M. Six, Hybride Finanzierung im Internationalen Steuerrecht am Beispiel von Genussrechten (Wien: Linde, 2008), 28 et seq. The author states that Genussrechte must be perceived as a super category under which PPLs (paritischen Darlehen) must be classified. In a recent Danish decision from the National Tax Board, a profit/participation right without ownership to a windmill project and not being a loan was considered an investment in a business and accordingly taxable/deductible. See SKM 2009.257 SR.

5 The EU Commission has initiated an analysis of the tax treatment of PPLs as a financing alternative for European businesses. Moreover, domestic practice in Belgium allowing rulings with respect to the tax treatment of hybrid instruments and PPLs, in particular, have been investigated under the EU Code of Conduct. The conclusion was that hybrid financing does not constitute harmful tax competition within the scope of the Code of Conduct. Accordingly, Belgium has reopened to access to obtain rulings on the tax treatment of transaction involving hybrid instruments, see Deloitte, Belgian Tax Alert (6 May 2009); see regarding the general practice of the Ruling Commission with respect to PPL, W. Heyvaert, ‘Ruling Commission Confirms Tax Treatment of Hybrid Debt’, Tax Notes International (2007): 25 et seq.

6 See Duncan, supra n. 2, 25.

7 See Report No. 540 on joint Nordic company law (1969), 89 et seq., mentioning the issues in 1928 and 1929 with AB Kreuger and Toll as the first, and Mattsson, supra n. 3, 178, noting that the first Swedish issuance took place in 1926.

8 Similar opportunities were granted in the other Nordic countries due to the joint Nordic report work on corporate law; see, e.g., Mattsson, supra n. 3.
Section 178 of the new Companies Act includes a company law definition of profit sharing bonds from which it appears that profit sharing bonds are bonds or other debt instruments bearing interest, the amount of which is wholly or partly dependent on the dividend the shares of the company yield or on the profit for the year. The provision implies that the general assembly or the board of directors can be authorized to decide on raising a loan against profit sharing bonds.9

Some countries have specific rules on PPLs whereas other countries apply legal practice to the issuance of PPLs. Clearly, this may give rise to uncertainty, double taxation and double non-taxation.

Based on the above it seems relevant to analyse the tax law treatment of such instruments in an international context. This is the background for the following analysis, which is based on the fundamental assumption that tax law should not influence the application of financial instruments if sound economic and business reasons in favour of using such instruments exist.

2. Structure and Economic Characteristics of PPLs

Despite the general term, PPLs do not refer to uniform instruments. The corporate law legislation includes no further guidelines regarding the design of the instrument and the yield.10 Danish and foreign issuances of PPLs come in many forms. PPLs are loans typically characterized by interest payments being wholly or partially dependent on the debtor’s profit, proceeds or yield.11 A fixed or variable interest may also occur.

The profits of the issuing company may thus be the controlling factor in determining the size of the interest rate and hence the yield on the instrument. Consequently, PPLs include a significant equity feature, as distribution of dividends is also linked to the profit of the issuing company.12 Accordingly, the hybrid character of PPLs appears from the fact that the yield from the debt instrument follows the yield of share capital. It should, however, also be recognized that debt-like equity instruments also exist. Such instruments make the distinction even more blurry.

PPLs often include an element of basis interest and an element of a profit-participating interest, where the basis interest expresses the creditor’s minimum yield, which is often less than the interest rate on plain vanilla loans. The basis interest rate may be a fixed interest rate or a variable interest rate.13

PPLs may also be combined with other hybrid features, including conversion right/obligation,14 subordination, super maturity, perpetuity, etc.15 It is not always possible to distinguish PPLs from cumulative non-voting preference shares.16 A new version of PPLs has appeared in Danish business life with the so-called Bank Package II from 2009, opening the possibility of using the instrument in a larger scale with respect to hybrid tier 1-capital provided by the Danish State to Danish banks.17

Obviously, an analysis of PPLs depends on what other hybrid features are integrated in the instrument. Such features may evidently influence the analysis. However, the following analysis of PPLs is mainly based on a simple version of the instrument including standard features such as profit-participating interest, subordination and a term of up to fifty years. We have not decided on the tax law status of loss-participating loans. This exact criterion plays a central part in classification as equity in several countries.

3. Financial Rationales

A certain degree of financial flexibility is obtained by issuing PPLs rather than traditional bonds. This is because the profit-participating yield on PPLs implies that the ongoing costs of capital fluctuate according to the profit of the debtor company, whereas the costs of capital relating...
to traditional bonds are fixed, independent of the debtor company's performance. Companies with very fluctuating earnings can thus minimize the risk of financial distress by issuing PPLs, as the costs of capital in periods with low earnings are equally low and vice versa.

Consequently, PPLs may for instance prove especially attractive to companies working under long-term contracts with the majority of the fee revenue being due by the end of the work performed and for companies investing in assets with capital gains not being crystallized until the sale hereof, including real estate. It is common for these kinds of companies that the current cash flow in the companies is low compared to the total expected long-term profit. Financial flexibility offered by PPLs may be essential to certain companies' ability to raise debt financing.

Other potential reasons for issuing PPLs may be to attract capital without having to dilute the group of current shareholders/owners in a company and the alternative to raising capital in family-owned businesses without the family losing control over the company. PPLs can also be of interest to capital-seeking companies, as investors may gain a higher yield than from usual bonds on which the issue price – if the market considers the company's prospects to be positive – may be higher than the nominal price.

By issuing PPLs as an alternative to ordinary debt, the creditor's and the shareholders' risk profile may coincide, as the creditor may be entitled to the same unlimited earnings potential as the shareholders. Consequently, if the shareholders invest in high-risk projects potential shareholder/creditor conflicts might be reduced, as the creditor's yield is in proportion with the assumed risk.

Finally, it is worth mentioning that yield profiles allowing or implying the debtor to be exempted from the obligation to pay interest or only low interest in periods with 'financial distress' without defaulting the loan are considered positive for financial rating purposes. PPLs can thus be obtained without damaging a company's rating to the same extent that a traditional loan would.

We now turn to the analysis of the tax law aspects of PPLs.

4. Domestic Tax Law Classification of PPLs

4.1. In General

From an overall perspective hybrid financial instruments give rise to several tax law issues. The same is true regarding PPL instruments. The tax law classification and treatment of such instruments may be uncertain from the perspective of domestic tax law. Obviously, even more uncertainty, risk of double taxation or tax planning opportunities may arise in a cross-border context where domestic classification principles of more than one jurisdiction are applied. The domestic tax law treatment of PPLs in selected states is analysed in the following sections.

4.2. Federal US Tax Law

Hybrid financing is widely used in the United States. In attaching different tax consequences to debt (i.e., interest deductibility) as compared to equity (i.e., dividends not being deductible), the US Internal Revenue Code necessarily presupposes that these alternative ways of financing a corporation can be distinguished from one another; however, the Code itself does not fix the boundary line.

Under US Law classific debt is defined according to case law as: ‘… an unqualified obligation to pay a sum certain at a reasonable close fixed maturity date along with a fixed percentage in interest payable regardless of the debtors’ income or the lack thereof …’. An identical wording is used in some specific tax law provisions, for example, IRC section 385(b)(1). Debt cannot exist if there is no enforceable obligation. The existence of such an obligation is determined on the basis of...
of applicable local or state law (common law). Equity treatment is ensured by using conventional common or participating stock. A stockholder is traditionally defined under case law as one who has the intention … to embark upon corporate adventure, taking the risks of loss attendant upon it, so that he may enjoy the chances of profit ….”

Classification of hybrid financial instruments under US law has given rise to numerous cases over a long period of time. Based on case law a range of debt/equity features are considered by the courts when analysing hybrid financial instruments. This test also applies to PPLs. Participation in the success of a corporation is clearly an equity feature and as such essential to equity status, but not necessarily inconsistent with a creditor-debtor relationship. This holds true if the participation takes the form of a right to receive a portion of the debtor’s above-target earnings or an option to convert debt into equity, as seen with convertible bonds. Participation in both gains and losses would generally undermine the requirement for certainty of return on the debt. The overall conclusion regarding the classification of PPLs in US law depends on the fact patterns of the instrument at hand. However, debt classification may be expected given the fact patterns assumed in this analysis.

4.3. German Tax Law

Hybrid financial instruments are widely used in Germany. In recent years the number of instruments has increased. As a starting point, the financing decisions of corporations in Germany may be made under the principle of contractual freedom. No statutory provisions are applicable for distinguishing between debt and equity from a tax law perspective, irrespective that different tax consequences are attached to the two financing alternatives. Nor are there any clear criteria prescribed by government pronouncements or court decisions. Thus, the classification of hybrid financial instruments for tax purposes generally follows the classification pursuant to the premises of German civil and corporate law, provided the instruments are governed by German law. Under the principle of Massgeblichkeits, German tax accounting generally follows the accounting treatment under commercial law, unless the tax principles specifically provide otherwise. Thus, general accounting principles must be applied.

In particular, it is important to evaluate if the instrument gives rise to rights characterizing a debtor-creditor relationship or if the instrument gives rise to rights characterizing a shareholder relationship. Based on the prevailing views in literature and jurisprudence from the BFH (Bundesfinanzhof), funds made available to a corporation give rise to a contribution to the corporation’s equity if the following criteria are fulfilled:

- a shareholder transfers an asset (such as money) that is susceptible of being contributed (einzugsfähig) to the corporation’s equity (this does for example, not include the use of intangible property);
- the transfer of the assets gives rise to capital that is not repayable on a fixed date and is not susceptible of being withdrawn by exercising unilateral creditor rights, such as by way of terminating a loan agreement; and
- the transfer results in liable capital; in other words, no repayment claim can be made in respect of such capital in bankruptcy proceedings involving the recipient corporation. The contributed capital can be repaid only if the corporation formally reduces its stated share capital or makes a resolution to distribute its balance sheet surplus after releasing capital reserves or the corporation is dissolved and liquidated.

Other authors have specified the test regarding PPLs and stated that such instruments should fulfil the so-called

Notes

28 See Hey, supra n. 32, 97.
29 See Jacob, supra n. 32, 320 and 445.
30 See Jacob, supra n. 32, 321 and 446; Trapp, supra n. 31, 321.
31 See Trapp, supra n. 31, 321.
32 See Hey, supra n. 32, 97.
33 See Jacob, supra n. 32, for the criteria listed in the text.
Genusrechts test in order to obtain equity classification for tax law purposes, including the criteria below:

1. The holder must have a right to participate in the current profits of the issuer of the instrument and cumulatively;
2. The holders must have a right to participate in the liquidation proceeds of the issuer. This should be met if the holder participates in the hidden reserves existing (built in-gains) at the level of the issuer, which again should be the case if the holder of the instrument cannot claim a return of capital prior to the liquidation of the obligor (or cannot do so for an extended period of time – for example, thirty years).

If at least one of the aforementioned requirements is not fulfilled, the profits derived from the instrument are treated as interest income (debt classification) at the recipient’s level and are subject to German taxation. If both requirements (profit participation and participation in liquidation proceeds) are met, the regular annual remuneration received by the holder as well as a potential capital gain derived from the instrument are generally tax exempt at the level of corporate holders (equity classification). Using the ‘Genusrechts test’ presented above, the treatment of PPLs according to German tax law depends on the fact pattern of the PPL at hand. The first test appears to be fulfilled with respect to PPLs. With respect to the second criterion, a long maturity may fulfill the test. This should also be the case if the debtor has an optional right to reimburse in cash or shares or by assigning the loan portfolio and/or if debtor or creditor may opt to convert all or part of the PPL into shares. Under a fact pattern where the test is not fulfilled, PPL (partiariasche darlehen) are considered debt for German tax purposes.

4.4. Danish Tax Law

4.4.1. In General

Hybrid financial instruments are not yet as common in Denmark as in other developed financial markets. No special rules apply for the taxation of PPLs in Danish tax law regardless of the practical use of the instruments. As early as in 1969, it was recognized that the application of this loan type will partly depend on whether the company can obtain a tax deduction for the interest expenses. Notwithstanding this clear assumption, the Danish legislator chose not to clarify the tax law treatment of PPLs and the yield from these – not then and not now.

The tax law issues raised in the context of PPLs are:
1. How the instrument should be qualified; 2. How the yield from the instrument should be qualified; and 3. The special issues following the above classifications under (1) and (2), including both the debtor and the creditor. These issues are analyzed in the following.

4.4.2. Classification of the Instrument

Prior to deciding on the tax law treatment of the yield on PPLs is a decision on the legal classification of the instrument as debt or equity.

In this respect there is initially reason to distinguish PPLs used in partnerships from PPLs used in corporations. Participation in profit has been a primary prerequisite for obtaining equity classification with respect to the private law delineation between partnership participation and loan agreements. Hence, participation in profit is a prerequisite for partnership participation.

In Danish law such delineation is less significant to corporate bodies, as equity in such companies is bound by formal procedures and legislation. Notwithstanding the similarity of PPL yield and dividends, a PPL cannot be considered to make up share capital neither for tax law nor private law purposes. This must also apply with respect to Danish investors holding PPLs issued by foreign companies unless the instrument constitutes formal share capital in the foreign country. This is the reason why the yield will not be considered dividends for tax law purposes.

Thus, there is only very limited support – if any at all – in existing case law in favour of reclassification of transactions (or entities) in fact owing their existence to company law regulation.

Notes

51 See, e.g., Börsenmeister, supra n. 32, 140, with references, Haun, supra n. 32, 72.
52 This part of the article is based on a previous article by the authors written in Danish and published as TSB 2009:480: ‘Overskudsafhængige lån – Om udformning, økonomiske rationale og den mangelfulde skatteretlige regulering’.
53 See Beretning, 1969, 90.
54 See, for instance, Michelsen, NTS (1999): 98 f.
55 In this section TSB is an abbreviation for Journal of Danish Tax Law [Tidsskrift for Skatter og Afgifter], hereinafter referred to as TSB. LV is an abbreviation for the Tax Assessment Guidelines [Ligningsvejledningen] published by the Danish tax authorities (SKAT).
57 See for instance Vestberg, i UIR (1962 B), 203.
58 It should be kept in mind that a PPL might also bear interest exceeding what follows from the arm’s length principle. In controlled transactions, potential surplus interest may thus be classified as disguised dividend in its capacity of the secondary adjustment, f. a. 2 of the Danish Tax Assessment Act. In case part of the PPL yield is subject to the same treatment as yield from equity. However, the instrument is not generally reclassified from a debt instrument to an equity instrument.

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To Danish companies, the relevant delineation, outside the formal share capital, constitutes the delineation between contributions and loans. The legal status in this respect may be summarized to certain loans in substance constituting a contribution to the debtor and thus may be treated as such for tax law purposes. 50 Regarding PPLs the question is whether the specific features of this instrument make the distinction relevant. The answer to the question is probably negative, as the distinction between loans and contributions is primarily relevant under other fact patterns not including hybrid instruments.

For Danish tax law purposes debt is usually defined as: (1) a legal obligation, (2) which is real, (3) which commits the debtor to repay the transferred amount, and which implies (4) an exchange of promises and payment between the parties. In principle there is no doubt that the PPLs express a debt obligation for private law purposes if issued by limited companies; cf. section 178 of the Danish Companies Act. 50

All Danish cases regarding the tax treatment of PPLs have classified the instruments as debt instruments covered by the Danish Act on Taxation of Gains and Losses on Claims and Debt. 51 This conclusion corresponds with the majority of the Advisory Council for Tax Legislation in Betænkning 1050/1985 section 3.5.3. Seemingly, the case in TIS 2008.407 SR is the first to directly address the issue whether PPLs constitute debt and not equity; see questions 2 and 3 of the case. The instrument at hand referred to was a ‘profit sharing loan’ for investment projects organized as limited partnerships. The maturity of the loan was twenty years, of which ten were instalment-free. The loan carried floating interest equalizing EURIBOR (six months) plus 1% point and a profit sharing interest calculated as 25% of the accumulated net profit (including profit from the sale of the property) in the limited partnership, which was calculated and paid out in year twenty. To the specific question the National Tax Board answered that the agreement was a valid private law loan agreement. Accordingly, the bondholders did not obtain any direct or indirect holders’ rights, including voting rights, etc. Further, the loan agreement served as a basis of enforcement. In addition it was stated that no basis for tax requalification of the profit sharing loan seemed to exist. Based on this it was finally concluded that the profit sharing loan should not be considered an equity instrument, neither for private law nor tax law purposes. This result seems correct.

Against this background the tax issue concerning PPLs has mainly been which part of the tax legislation regarding debt applied. 52

4.4.3. One or More Instruments

As with most financial instruments, the question often arises whether one or more financial instruments are integrated into the instrument at hand and whether the tax law treatment must be made bifurcated or integrated. This issue is also relevant for PPLs.

PPLs have been treated as one integrated instrument in Danish tax law. 53 In the case the National Tax Board stated that the nominal loan amount, the profit sharing part and the premium at repayment cannot be separated and must thus be considered as one and only one instrument.

4.4.4. Classification of Yield on Profit Participation Loans: Interest, Capital Losses or …?

In General

Once established that PPLs are in principle debt, the next question is to analyse the specific tax law treatment of the yield on the instrument. As a starting point interest as well as capital gains/losses must be included in the calculation of the taxable income. However, this does not cause the delineation between the two types of return on capital to be irrelevant. For instance, there is a difference in terms of the timing, which is of great practical importance. Further, losses on claims on group companies cannot be deducted, whereas interests are not generally restricted in a similar way.

From the perspective of issuers/debtors, the delineation of interest payments against capital losses covered by the Danish Act on Taxation of Gains and Losses on Claims and Debt is of great interest. From the perspective of the investors, the focus is primarily concentrated around the notion of interest payments, but also in the delineation against capital gains covered by the Danish Act on Taxation of Gains and Losses on Claims and Debt, including whether section 29(3) of the Danish Act on Taxation of Gains and Losses on Claims and Debt on structured bonds applies to PPLs. These issues are discussed below.

Notes

50 Please refer to the preliminary works to the Act on Taxation of Capital Gains and losses on Shares s. (67) and (8); cf. s. 2(4) in the explanatory notes to Act No. 412 dated 14 Jun. 1995 (L53/95), where it is stated that if it is clear at repayment of a loan that debtor would not be able to repay the loan, the loan has not been recognised as a loan for tax purposes but rather a gift, a contribution or similar. This practice has, e.g., been analysed by Bundgaard, SpO (2004), 355 et seq. and in Skatteret & Civilret (2006), 999 et seq.

51 It is generally recognized that the notion of debt in the Danish Act on Taxation of Gains and Losses on Claims and Debt should be interpreted in line with the underlying private law concept of debt, see, e.g., Bundgaard, supra n. 49, 908 et seq.


53 Similarly for Norwegian law, please refer to Matre, supra n. 12, 456 et seq. (459, n. 16). Norwegian law does not consider a traditional PPL to be equity. This is only relevant if the creditor also participates in the debtor’s loss, which might occur if the repayment of the loan depends on debtor’s earnings or if the loan is granted on non-recourse terms.

54 See, e.g., TIS 2008.407 SR, the answer to question 1.
The part of the yield which can be subsumed under the notion of interest is considered interest from a tax law perspective, whereas yield falling outside this scope qualifies as capital losses/gains on debt.54

Consequently, the tax law question is primarily whether the yield falls within the scope of the narrow tax law notion of interest with the consequence that the debtor can obtain an interest deduction. Section 6e of the Danish State Tax Act does not provide guidance as to when the right of deduction of interest is expected to be granted, which is why the issue is left to the narrow interest definition generally applied in Danish tax law.55 Based on case law the concept is usually summarized in these four conditions:56

1. They must be considered for the availability of the tax law notion of interest.
2. They must be based on a legal obligation.
3. They must be calculated for a specific period as a percentage of the nominal disposable amount available at any given time.
4. They must be paid or received successively.

The Basic Yield

Undoubtedly, the basic yield of PPLs falls within the scope of the tax law notion of interest. This applies no matter if the basic yield is fixed or variable as long as the above conditions are met.57

Accordingly, there is no doubt about the tax law treatment of the basic yield of a PPL in Danish tax law.

Profit-Participating Yield

The profit-participating part of the yield of PPLs does not fall within the scope of the notion of interest as defined in case law.58 If the profit-participating yield cannot be qualified as interest, it must consequently be considered capital loss/gain. This is also the outcome of the existing administrative practice.59

The background for considering profit-participating interest as not falling within the scope of the notion of interest is that it is not a periodical payment calculated as a specific percentage of the outstanding debt at any given time in the period.60 Profit-participating yield only constitutes capital loss if it is not possible to calculate the nominal interest rate in advance.

Based on the above it is concluded that according to current law profit-participating yield on PPLs is considered as capital gains for the creditor and as capital losses for the debtor. This conclusion is in line with administrative case law.

In TIS 1998.77 LR the National Assessment Council found that the profit-participating yield should be treated as a capital loss for the debtor because the yield is not covered by the notion of interest, as the basic condition that interest is calculated as a percentage of the outstanding loan at any given time had not been met. The size of the profit-participating yield was calculated on the basis of the debtor company’s net profits. More specifically, it was calculated as the debtor company’s net profit multiplied by the return on equity, and a cap or a floor might be used in the calculation of the yield. The yield was due to annual payment. The National Assessment Council could not, with the necessary certainty, answer the question of whether the debtor should be allowed a deduction for the capital loss. The reason was that the profit-participating yield was considered a revaluation, which affected the assessment of whether the loan term was characterized as having been issued at an original discount or not. Finally, the National Assessment Council also mentioned that the annually calculated profit-participating yield was to be considered a partial repayment of the loan.61 Thus, a partial repayment of the loan occurs each time the profit-participating yield is paid.

In TIS 2006.127 LR, the tax treatment of PPLs was once again decided upon. This time it was a property bond with variable additional interest rate. The maturity of the loan was thirty years, and it was raised and repaid at par. Further to the fixed interest, the bond also had a variable additional interest rate based on the net profit/loss of the property management in the property company. The fixed as well as the variable interest payments were due annually. Also in this decision, the National Assessment Council considered the variable additional interest rate to be price revaluation of the bond, as covered by the Danish Act on Taxation of Gains and Losses on Claims and Debt;
cf. the response to question 4. Consequently, the issue was what consequences this would lead to. In this case, the tax authorities illustrate very well how the price revaluation line of thinking can be transferred to the loss calculation, according to section 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. This issue is analysed specifically infra in section 4.5.

A similar result is seen in TIS 2008.407 SR concerning a twenty-year PPL where the profit-participating part was calculated and paid in year twenty. The profit-participating part was calculated as 25% of the accumulated net profit, measured from the time of disbursement of the loan until the time of calculation, including net profit on sale of real property.

The price revaluation line of thinking seems to be traceable back to at least the National Assessment Council's decisions in TIS 1989.249 and TIS 1989.288, where an additional interest rate was considered a price revaluation in both cases.

The internationally occurring 'ratchet mechanism' is a variant of PPL interest, but in reverse. The fixed interest rate may increase if the specific 'performance thresholds' are not met by the debtor who can thereby be disciplined to perform. Also here, the notion of interest seems to be too narrow from a Danish perspective, resulting in the yield to be classified as a capital loss in accordance with the case law presented above.

4.4.5. On the Calculation of the Debtor's Losses

In the following it is analysed how the deduction of losses should be calculated in the light of the case law mentioned above. The dominant main rule regarding the timing of capital gains and losses is the realization principle following from section 25(1) of the Danish Act on Taxation of Gains and Losses on Claims and Debt, according to which gains and losses must be included in the income year in which the gains or losses are realized. Taxation according to the realization principle is triggered when a capital gain or loss has been realized. This may occur when the debtor (wholly or partially) repays the debt, including payment of the profit-participating yield according to current practice.

In TIS 1998.77 LR the National Assessment Council stated that the deduction of PPL interest could be made at the time it was calculated since the interest falls due at that time. In conclusion, it was stated that the annually calculated profit-participating yield, with payment due in immediate connection with the financial reporting, should be considered a partial repayment of the loan for tax law purposes. Thus it seems that the National Assessment Council did not specifically decide on the practical effect of this statement, but at the same time the National Assessment Council appeared to presuppose that the debtor had a full right to deduct the payments at the time of payment of the profit-participating yield. At the same time, it also seems to be assumed that the realization principle applies.62

TIS 2006.127 LR is the only decision in which an actual calculation is made of the actual deductions and which consequently illustrates the timing of the deductibility of the yield. Due to this decision, there will not be full deductions for current yields in the actual income years. There will only be deductions for an amount equaling the relation between on the one hand the repayment price less deductions for the purchase price and on the other hand the repayment price; cf. section 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt.

It is acknowledged in the decision that this method of calculation creates unfortunate and impractical results, as the loss is calculated wrongfully because the final repayment price is not known until the final repayment of the loan. The problem is illustrated by an example with a simplified situation with a three-year loan with a purchase and repayment price of DKK 100 and an additional interest rate (the profit-participating yield) in all years of DKK 3, which is paid consecutively each year. The debtor's annually capital loss must be made up according to the following formula:

\[
\frac{(\text{repayment price} - \text{purchase price}) \times \text{instalments}}{\text{repayment price}}
\]

Consequently, the deductible losses in years one to three may prove to be as shown below:

Year 1:

The annual additional interest of DKK 3 is added to the debt (the repayment price) and is due to payment at the time of accrual as instalments. This implies that the debtor has a deductible capital loss of

\[
\frac{(103 - 100) \times 3}{103} = 0.08738 \text{DKK}
\]

Year 2:

The annual additional interest of DKK 3 may be rolled into the principal, and this implies that the repayment price is increased by further DKK 3 to a total amount of DKK 106. Hence, debtor has a deductible capital loss of

\[
\frac{(106 - 100) \times 3}{106} = 0.16981 \text{DKK}
\]

Note

62 See also TIS 2003.788 LR, in which reference is made to the National Assessment Council’s decision in TIS 1998.77.
Year 3:

As the maturity of the loan is three years, both the annual additional interest and the entire outstanding debt will be paid as instalments, which adds up to a total deduction of

\[
\frac{(109 - 100) \times 103}{109} = 8.50459\text{DKK}
\]

The total capital loss should be DKK 9 and as the above formula results in a total capital loss of DKK 8.76178, the debtor needs to deduct an additional capital loss of DKK 0.23822 (9 – 8.76178). The difference is due to the fact that an incorrect calculation of the loss was made in years one and two, as an incorrect repayment price had been used. The repayment price should have been DKK 109, but this amount remains unknown until year three. Due to this the National Assessment Council suggests that the taxpayer requests for a reopening each year of prior years’ tax calculations. This does not cause significant problems in the above simple example, as it concerns a three-year loan. The loan referred to in the decision is a thirty-year loan, which implies that the taxpayer should request for a reopening each year in thirty years from the issuance of the loan and then for each of the years prior to the year in question.

However, in practice the main issue is not that the loss is miscalculated but that the actual deduction is deferred to the time of final repayment of the loan, which is why the debtor cannot deduct the losses realized continuously (in the example the DKK 8.5 in year three regardless of the actual continuous payments of profit-participating yield). Rather, debtor can only deduct the proportionate capital loss of the periodic instalment and hence not the entire profit-participating yield in the period in which the loss is actually suffered. This issue has not been addressed in the existing case law, and the matter seems to require intervention from the legislator.

The problem is illustrated in TIs 2008.407 LR, in which the variable yield was not payable until repayment of the loan. This results in the situation where deductions were not allowed until the final repayment. Most recently, the question is seen in TIs 2009.284 SR regarding the tax consequences of issuance of hybrid tier 1-capital issued under the Danish Bank Package II.63 This case also includes the issue of accrual of the debtor’s deductions of profit-participating yield. Not surprisingly it is stated that a position is not taken to the technical calculation of the deduction for the capital loss concerning the repayment of the debt when applying the realization principle. The loss must be stated in accordance with section 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt.64

According to section 25(1) of the Danish Act on Taxation of Gains and Losses on Claims and Debt, the realization principle applies. According to the wording of the provision, the debtor is allowed to deduct the full loss in the income year in which the loss is realized. In order for the debtor to have full deduction right for the profit-participating yield, when this is due, it is a requirement (1) that the entire profit-participating yield can be considered as a capital loss and (2) that this loss is considered to be realized on the maturity date. In combination with the price revaluation mindset, the calculation of loss under section 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt is not optimal.65

In other words, the problem is caused by the interaction between sections 25(1) and 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt, the latter constituting the technical supplement regarding the actual calculation of losses on debt. Notwithstanding that a profit-participating yield is actually paid, the problem seems to be that the tax authorities will not acknowledge the loss at the time of payment, as no authority exists to deviate from section 26(4) of the above act. It is also not clear which principles should be applied under a more free interpretation.

The solution put forward by the National Assessment Council entailing that the taxpayer – each time a profit-participating yield is paid – must request for reopening for prior years so that correct statements of losses can be made for these years.66 This so-called solution is hardly sufficient and will impose administrative burdens on the taxpayer. The answer is based on a simplified example with a three-year loan illustrated above. Evidently, a reopening of such a case is possible. But it is hardly a solution for thirty-year loans or loans with even longer maturities. Also, it cannot be precluded that the necessary reopenings are not allowed of prior years’ income statements pursuant to the rules on ordinary and extraordinary assessment in sections 26 and 27 of the Tax Administration Act. This makes it virtually impossible to know the legal position of a Danish issuer of PPLs in advance.

A practical solution to the problem would be to consider engaging in ongoing repayments and new establishments.

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63 Act on State Recapitalisation of credit institutions (L 102) introduced 21 Jan. 2009.
64 This is not the first time legislation makes it possible to provide loans in which part of the yield is yield participating in the debtor’s profits without concretizing the tax consequences. This was also seen when introducing Act No. 1008 dated 23 Dec. 1998 (L 94) on the Fund for Industrial Growth’s possibilities for supporting risky development projects. In the explanatory notes to s. 3 of the bill, it was noted on the tax law consequences on the new loans that companies will, when stating their taxable income, get a deduction of the part of the repayment to the Fund for Industrial Growth depending on the profit or turnover. Thus, no position was taken on the timing or calculation of the deductions.
65 In SR-Skat 2004, 186 et seq., Daily Mailon notes that the debtor is only allowed a proportionate deduction for the yield paid and that the deduction right and the cash flow are not correlated. Further, it is stated that one could take a sympathetic view of the fact that the Assessment Council opts to consider the yield a price revaluation, but that this causes problems when calculating capital gains and losses. Norwegian tax law seems to allow full deduction for the entire yield of the loan; see Matre, supra n. 12, 462.
66 See the answer to question 6a in TIs 2006.127 LR.
of PPLs to the extent it seems reasonable for business purposes.

In conclusion, current law in this field is not satisfactory. Finance costs will not be fully deductible in several cases if the current administrative practice is upheld. There seems to be many good arguments to allow an ongoing deduction, also for profit-participating yield, paid currently but outside the scope of the narrow notion of interest.

Optional Use of the Mark-to-Market Principle

As of the income year 2010, companies can decide to use the mark-to-market principle with respect to accruals of taxable gains and losses on debt (1) admitted to trading on a regulated market or (2) in foreign currencies not admitted to trading on a regulated market; cf. section 25(5) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. The decision has to be made for all debt within the same category, that is, all debt admitted to trading on a regulated market and/or all debt in foreign currencies not admitted to trading on a regulated market. Once the mark-to-market principle is chosen, a change of accruals principle can only be made with permission from the Danish tax authorities.

In the following it is analysed whether the practical problems that occur under the realization principle as illustrated above are solved if the mark-to-market principle applies.

According to the mark-to-market principle, gains and losses on debt are estimated as the difference between the value of the debt at the beginning and at the end of a tax income year, less all instalments during the period. If the debt is issued or undertaken during the income year, the value of the debt at the time of issue/when it is undertaken is set as the entry value. Consequently, the value of the debt and therefore the applicable valuation principle determines the size of the taxable gain or deductible loss.

No clarification on how the value of debt should be estimated is provided by the wording of the law or the preliminary work. According to the tax assessment guidelines, gains and losses are assessed as the difference between the (bond) prices at the beginning and at the end of the income year. Accumulated losses or gains that occur during the period— for example, due to the purchase of a claim or due to the undertaking of debt— must be included in the assessment of the taxable income. However, it is not specified whether the value of the debt is set as the market price or the face value.

It is uncertain how the tax basis on debt issued before the income year 2010 is valued in the tax income year 2010. However, it is most likely that the value of the debt at the time of issuance is set as the tax basis in the income year 2010.

It is not clarified how the value of debt should be estimated according to the mark-to-market principle for tax purposes. Furthermore, no case law exists on how the calculation of deductible capital losses occurring due to payments of PPL yield should be assessed according to the mark-to-market principle.

Regardless of this uncertainty, it seems possible to argue that the value of the PPL is equal to the debtor’s economic burden forced by the undertaken liability, that is, the face value of the PPL and the PPL yield. Accordingly, it seems likely that the use of the mark-to-market principle results in an ongoing deduction of the PPL yield in the year of which it is paid, as the yield is added to the repayment price and consequently the value of the debt.

4.4.6. Tax Treatment of the Creditor

Realization Principle or Mark-to-Market Principle?

In general, as of 2010 companies must include gains and losses on claims in their taxable income according to the mark-to-market principle; cf. section 25(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. Consequently, if the PPL is not (1) admitted to trading on a regulated market or (2) issued in foreign currencies not admitted to trading in a regulated market, asymmetry exists in the taxation of the debtor and the creditor due to the difference in the applicable accruals principles. Asymmetry in timing may be significant if the calculation method introduced by the National Assessment Council in TIS 2006.127 (cf. above) applies, as this method postpones the deduction of the losses on debt until the repayment of principal.

For individuals the realization principle applies as the general accruals principle. However, if the claim qualifies as a financial contract within the scope of section 29(3) of the Danish Act on Taxation of Gains and Losses on Claims and Debt, the gains and losses are mainly taxed in accordance with the mark-to-market principle; cf. section 33(1) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. This can also result in an asymmetric taxation of the debtor and the creditor due to the difference in the applicable accruals principles.

It should be noted that the mark-to-market principle applies to instruments covered by the scope of section 29(3) on financial contracts regardless of whether the creditor is an individual or a company. However, as the mark-to-market principle is the general timing principle on taxation of companies’ gains and losses on claims as of 2010, section 29(3) is of less importance and in

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67 Debt issued in other currencies than Danish Kroner (DKK).
68 This option is made available as a consequence of the general mark-to-market taxation of companies’ claims enacted as a result of the tax reform in 2010 (L202). This option minimizes the existing asymmetry in taxation of the debtor and the creditor due to the application of different accruals principles.
69 See LV AD 2.13.3.
some cases of no relevance with respect to claims held by companies.

Covered by the scope of section 29(3) of the Danish Act on Taxation of Gains and Losses on Claims and Debt are gains and losses on claims not covered by sections 4 and 5 if the claims meet the following requirements:

(1) the claim must be wholly or partially regulated on the basis of the development in prices etc. on securities, goods and other assets etc.; and

(2) the development is of a nature that can constitute the basis for a financial contract.

Both requirements must be met in order for the claim to fall within the provision. Accordingly, if one or both of the requirements are not met, gains (and losses) are accrued and taxed in accordance with the general provisions in the Danish Act on Taxation of Gains and Losses on Claims and Debt, that is, in general the mark-to-market-principle for companies and the realization principle for individuals.

The requirements of section 29(3) of the act must be interpreted broadly. As an example, it is insignificant how the profit-participating yield is calculated with respect to the assessment of whether PPLs fall within the scope of section 29(3). Furthermore, the requirement that the development (ii) of such a nature that can constitute the basis for a financial contract is considered met if the development is based on a tangible asset (such as currency, claim, share or goods) or on an index, an interest, a liability etc. A more explicit delineation of the general scope of this requirement appears neither in the mentioned preparatory work nor in case law. The National Assessment Council and the National Tax Board have on several occasions taken a position on the scope of section 29(3).73

According to the preparatory work to section 29(3),74 PPLs are covered by the scope of the provision.75

Recall the wording of the first mentioned requirement according to which the claim must be wholly or partially regulated on the basis of the development in prices etc. on securities, goods and other assets.

Based on the wording of section 29(3), good arguments exist to argue that PPLs do not fall within the provisions of section 29(3), as the PPL yield is not a regulation of the claim but of the yield. However, this provision does not only apply if the nominal value of the claim is regulated -- but applies in respect to regulation of all types of yields that constitute a gain or loss for tax purposes, that is, any yields but interests.76 The courts have not yet considered whether regular PPLs fall within section 29(3) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. However, the National Assessment Council and the National Tax Board have been asked the question and are of the opinion that certain PPLs have the necessary characteristics to fall within this provision.77

Danish Withholding Tax on Cross-Border PPL Yield?

Foreign creditors may be subject to Danish withholding tax on interest payments and certain capital gains pursuant to section 2(1) paragraph b) of the Danish Corporation Tax Act. This provision should also be analysed in an international PPL context.78

This provision was implemented acknowledging that evident tax planning openings arose by only introducing withholding taxes on interest payments and not on capital gains. The provision does not cover all capital gains but only those arising from a premium fixed in advance compared to the value at the date of establishment. The provision applies when the claim is established on such terms that it must be repaid at premium -- notwithstanding if at the time of establishment it was controlled debt or not. The taxable capital gain is made up as the difference between the value of the claim at the time of establishment and the repayment price agreed upon. In principle this corresponds to section 26(4) of the Danish Act on Taxation of Gains and Losses on Claims and Debt. On the interaction with the rules on thin capitalization, section 11 of the Danish Corporation Tax Act prescribes that the provision does not apply to 'amounts' that have been subject to withholding tax. As no reference is made to paragraph h), it must be submitted that limitation in deductions pursuant to section 11 of the Corporation Tax Act can still be

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79 See the preparatory work to s. 3(4) of Bill No. 98 (adopted by Act No. 407 dated 1 Jun. 2005) and the remarks submitted by the Fiscal Affairs Committee on 4 May 1995 to Bill No. 98.

80 See, e.g., TFS 2006.4 LR, TIS 2008.962 SR, and SKM 2009.53 SR.

81 See the preparatory work for s. 29 of the Danish Act on Taxation of Gains and Losses on Claims and Debt.


84 See the response paper to the Institute of State Authorized Public Accountants in Denmark (Foreningen for Statsautoriserede Revisorer – FSR), where the Danish tax minister would not confirm that regular PPLs with an interest that depends on the profit in the debtor company is not covered by the scope.

85 See the preparatory work for s. 29 of the Danish Act on Taxation of Gains and Losses on Claims and Debt.


89 In German law PPL payments generally attract withholding tax according to EStG s. 43. Finanzgericht Münster recently ruled that an instrument was a PPL and that there was a withholding obligation (effectively 26.375%) for the payments; see Finanzgericht Münster, 10-K-4972/05-Kap, Urteil vom 2 Jul. 2009.
made for capital losses while also being subject to withholding tax on the capital gain.

The main rule of the Danish Act on Taxation of Gains and Losses on Claims and Debt is that companies must include profits and losses on debt in the taxable income; cf. section 6 of the Danish Act on Taxation of Gains and Losses on Claims and Debt. According to a specific provision in section 7(2) of the act, loss deduction was denied if the debt was repayable at a premium fixed in advance compared to the value at the original date of issue. This specific provision moreover required that debt was nominated in DKK and that the nominal value of the interest rate equalled or exceeded the minimum coupon rate. In 2010 the concept of the minimum coupon rate was abolished in Danish tax law, and the provision in section 7(2) was consequently repealed. However, the historical analysis of the applicability of the provision may still be relevant when considering whether Danish withholding tax may be levied on profit-participating yields. It seems correct to assume that the crucial issue is whether it can be predicted that a capital loss will incur and not, as has been pointed out in administrative practice, whether the minimum coupon rate has been fulfilled. The latter reasoning is not convincing, as PPLs are, in principle, loans at par and cannot rightfully be considered repayable at a premium set in advance compared to the value at the original date of issue. The essential aspect of PPLs is that it cannot be known in advance whether the development will lead to payment of the profit-participating yield. The fact that the price revaluation line of thinking is recognized in practice does not mean that the debt must be repaid at a premium fixed in advance. Based on the above, it seems correct to conclude that PPLs in principle did not meet the requirement of section 7(2) of the Danish Act on Taxation of Gains and Losses on Claims and Debt and as a consequence will not meet the test regarding withholding tax on such capital gains.

The same uncertainty applies on the creditor side. How-ever, it remains a question open to discussion how profit-participating yield on convertible PPLs should be treated for tax law purposes.

5. Applicability of EU Corporate Tax Directives on PPL Yield

5.1. In General

In a European Union context intercorporate dividends and interest payments are some of the few areas which have been harmonized within corporate tax law through the parent/subsidiary directive (hereinafter PSD) and the interest/royalty directive (hereinafter IRD). Accordingly,
these directives are the most important sources of EU tax law with respect to cross-border hybrid financial instruments including PPLs, as no specific legislation aimed at such instruments has been introduced so far. Obviously, hybrid financial instruments give rise to a number of issues with regard to the PSD and the IRD. The reason for this is obvious, since the directives are primarily designed to address tax law issues regarding pure equity and pure debt instruments.90

5.2. The Notion of Interest and Debt under the Interest/Royalty Directive: Positive Demarcation

Interest payments between associated companies within the European Union may avoid withholding tax (but not income tax) according to the IRD. In Article 1, paragraph 1 of the IRD, it is stated that interest payments arisen in a Member State shall be relieved from any form of tax in the source state under the condition that the beneficial owner of the interest is a company or a permanent resident in another Member State belonging to a company in a Member State. It is required under the IRD that both the debtor company and the creditor company fall under the definition of a ‘company of a Member State’, that is, mentioned in the annex to the IRD, and being a taxable entity resident in a Member State. Another important requirement is the association between the companies as defined in Article 3, paragraph 1(b). A company is considered to be associated with another company if (i) directly owns at least 25% of the capital of the other company, (ii) if the other company directly owns at least 25% of the capital of the first company, or (iii) if third company directly owns at least 25% of the capital of both the payer company and the receiving company. These general requirements, which should be met to apply the IRD, are not analysed in the following. The core of the analysis is the payments included under the scope of the directive. The IRD is more informative than the PSD when it comes to defining the notion of interest, since the notion of interest is defined directly in Article 2, paragraph 1(a) of the directive as:

(a) the term ‘interest’ means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest

The background for the interest definition is explained in COM (1998)67 final, page 6, which states:

... The term ‘interest’ as used for the purposes of this Directive denotes in general all income from debt-claims of every kind. The definition is based on that used in Article 11 of the 1996 OECD Model Tax Convention on income and on capital, with the exception of income from government securities which is not relevant to this Directive. Penalty charges for late payment do not really constitute income from capital, but are rather a special form of compensation for loss suffered through the debtor’s delay in meeting his obligations. These charges are therefore, as in Article 11 of the OECD Model Tax Convention, not regarded as interest for the purposes of this Directive.

It is interesting to note that the notion of interest is intended to be similar to the notion used in the OECD Model Tax Convention. The notion of debt-claims also seems broad. The wording refers to debt-claims of any kind. Based on this, in our opinion, any debt-claim which is a debt-claim for private law purposes falls under the scope of the IRD. Moreover, the notion of interest under the IRD also includes capital gains.91

5.3. Exclusion of Certain Hybrid Financial Instruments: Negative Demarcation

At a first glance, the notion of interest of the IRD is particularly wide and also includes yield from certain hybrid financial instruments, including PPLs.92 However, Article 2 should be read in conjunction with Article 4 of the Directive in order to clarify the actual scope of the definition.93 In Article 4 of the IRD, the source state is given the rights to deny the benefits of the directive in cases where some common types of hybrid financial instruments are used. It remains unclear why the Member States have been given the option to exclude certain financial instruments from the scope of the Directive rather than generally excluding the instruments from the scope of the Directive. The wording of Article 4 is the following:

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90 See for an extensive study of the applicability of the directives on hybrid financial instruments: Bundgaard, Classification and Treatment of Hybrid Financial Instruments and the Remunerations Thereon under EU Corporate Tax Directives, CORIT Discussion Paper No. 6, 2010, forthcoming in European Taxation.
91 Government Bonds are not covered by the Directive since Member States are not considered companies that fall under the scope of the Directive; see Gusmeroli, ET (2005), 39 et seq (44).
93 Ibid.
Article 4

Exclusion of payments as interest or royalties

1. The source State shall not be obliged to ensure the benefits of this Directive in the following cases:
   (a) payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State;
   (b) payments from debt-claims which carry a right to participate in the debtor’s profits;
   (c) payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor’s profits;
   (d) payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.

The overall policy background for this provision is explained in COM (1998)67, page 8, commenting a previous draft for the IRD, where the following is stated:

… Member States are permitted to exclude certain payments which may fall under the notion of interest but which actually have the character of distributed profits, income treated as a return of capital or income from hybrid financing. This could arise, for example, under the provisions of a Double Taxation Convention in force between the Member State where the interest arises and the Member State of the beneficial owner or under the law of the Member State where the interest arises.

Interest that has been re-characterised as distributed profits ought to benefit from the provisions of Directive 90/435/EEC provided all other requirements of that Directive are met, in order to avoid double taxation of such profits.

Thus, the Member States may decide whether the benefits of the IRD apply with regard to financial instruments under the scope of Article 4 of the Directive. The enumeration of excluded financial instruments should be considered exhaustive in contrast to previous drafts to the Directive. It is uncertain which legal weight should be given to the statement in COM (1998)67, page 8, whereby income from hybrid financial instruments may be excluded from the IRD, for example under the provisions of a Double Taxation Convention between the countries or under the law of the Member State where the interest arises. In other words, the 1998 statement seems to rely on the classification under a tax treaty. Such a link is not found in the wording of the final version of the IRD. In our opinion, as a consequence, the interpretation of the IRD should not rely on the statement by the Commission regarding the previous proposal for the Directive.

We now turn to the further elaboration of the consequences of this with respect to PPLs.

Payments which are treated as a distribution of profits or as a repayment of capital under the law of the source state may be excluded from the scope of IRD by the Member States according to Article 4, paragraph 1(a). This exclusion has a rather wide scope and should include yield from some forms of hybrid financial instruments as well as interest subject to thin capitalization legislation in the source state, which result in a reclassification of interest to dividends. Moreover, the exact meaning of the wording ‘which are treated’ is unclear. It does not seem to be a correct interpretation to allow the Member States a general possibility to classify the yield on hybrid financial instruments as they please. This may include PPLs insofar such instruments are reclassified under the law of the source state.

Moreover, payments from debt-claims which carry a right to participate in the debtor’s profits are explicitly excluded according to Article 4, paragraph 1(b). This potentially affects some PPLs, participating bonds, jouissance rights and silent partnerships from the scope of the Directive. According to Eberhartinger & Six, this provision in combination with the PSD provides Member States the possibility of totally excluding jouissance rights and silent partnerships from the Directives by treating them as debt under national law, thus exempting them from the benefits of the PSD, and then using Article 4, paragraph 1(b) of the IRD to exempt them from the benefits of that Directive. The wording of the provision makes reference to ‘debtor’s profits’, which moreover leads to the exclusion of instruments where the amount of interest payments is strictly connected to the profit of another entity than the debtor, for example, a subsidiary of the debtor. This covers so-called ‘exchangeables’.

The Directive does not provide a direct explanation for the limitations of the scope of Article 4. However,
it may be said that a restrictive interpretation of the Directive is correct and justifiable because the provisions in Article 4 of the Directive are meant as exceptions to the general rule of the application of the Directive as stipulated in Article 2. Therefore, a broader interpretation of these exceptions to include situations that are not explicitly included in the text would run the risk of frustrating the purpose of the Directive.\(^\text{102}\)

In conclusion, the scope of the IRD with respect to PPLs has been specifically addressed in the wording of Article 4 of the IRD. Based on this Member States seem to have fairly good possibilities to exclude PPLs from the scope of the IRD. This may give rise to uncertainty from a tax payer perspective.

### 5.4. Yield on Instruments Excluded from the Scope of the Interest/ Royalty Directive

As a consequence of the presented negative demarcation of the payments falling under the scope of the IRD, the question arises whether the payments fall under the scope of the PSD as profit distributions. It is commonly agreed in commentary that payments excluded from the scope of the IRD under Article 4, paragraph 1(a) should fall under the scope of the PSD instead.\(^\text{103}\) This was also explicitly stated in COM (1998) 67 final, regarding the previous draft to the IRD. A similar result is not presupposed with respect to the interest payments mentioned under Article 4(b)-(d), where the 1998 proposal in Article 4 only referred to interest ‘that has been re-characterized as a distribution of profits’. Article 4, paragraph 1(b, c and d) applies to cases where the treatment under the domestic tax law of the source state corresponds to the general definition of interest in Article 2(1) of the IRD\(^\text{104}\) but where other features of the instrument imply that the instrument should not be included under the scope of the IRD. Accordingly, payments on hybrid financial instruments falling under the scope of Article 4, paragraph (1), b, c, or d may be subject to double taxation in cases of classification inconsistency between the Member States involved. However, if such payments are in fact reclassified as ‘distributed profits’, the same interpretation as regarding covert distributions ought to apply to such payments as well. Thus the PSD may be said to take precedence over the IRD.

According to Terra & Wattel, since the originally proposed reference to the PSD for such re-characterized income as dividend has been deleted in the adopted final version of the IRD, this means that payments on hybrid loans may fall between two stools.\(^\text{105}\) As also stated by Brokelind, there is neither agreement in doctrine on its extent nor in ECJ or any other national court case law regarding the applicability of the PSD with respect to hybrid financial instruments.\(^\text{106}\) The author analyses the application of the PSD regarding PPLs regretting that the Swedish Supreme Administrative Court has rejected to refer a case to the ECJ regarding the application of the PSD on income from PPLs.

In our opinion, the result of the analysis should be the same as regarding interest being reclassified from a thin capitalization/arm’s length principle line of thinking and hybrid instruments in general. The two situations are somewhat overlapping and may lead to the same unfavourable tax position. Consequently, if the conclusion is that Member States by way applying the exemption in Article 4 of the IRD can avoid granting the benefits under both Directives, this should also apply to reclassified interest according to domestic thin capitalization legislation. However, the intent of the EU commission can be said to be more clearly expressed with respect to yield on hybrid financial instruments falling outside the scope of the IRD as a consequence of the application of Article 4(1) of the IRD. One important difference should, however, be borne in mind, that is, that Article 4 of the IRD does not automatically concern payments, which are classified as dividends in the source state. Application of the PSD in such situation should lead to a situation where yield not treated as dividends in the source state would be covered by the PSD. Such a result would go beyond the purpose of the Directives.

### 6. Classification of PPL Yield under Double Tax Treaties

#### 6.1. In General

In the context of double tax treaties, the yield on hybrid financial instruments may classify as dividend payments under Article 10, as interest payment under Article 11 or as other income under Article 21 in double tax treaties agreed on the basis of the OECD Model Tax Convention.\(^\text{107}\) Moreover, Article 7 and Article 13 of treaties based on the OECD Model may be of relevance. For the sake of simplicity, only the dividend provision and

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**Notes**

102 See Distaso & Russo, supra n. 92, 150.
103 See Eberhartinger & Six, supra n. 99, 227 and Distaso & Russo, supra n. 92, 150.
104 See Eberhartinger & Six, supra n. 99, 228.
107 See in general Kühler, Pötsch & Schaumburg, supra n. 32, 137 et seq., M. Six, Hybride Finanzierung im internationalen Steuerrecht am Beispiel von Genossenschaften (2007), 94 et seq. and Brissemeister, supra n. 32, 393 et seq.
the interest provision are analysed in the following with respect to PPLs. The demarcation is of great importance since the taxing right under the treaties differs depending on the type of income.

PPLs are sufficiently common for specific provision to exist in a number of tax treaties.\(^{108}\) The US Model convention Article 11(5) includes a specific provision regarding the taxation of profit-participating yield, allowing the source state to tax the interest at a rate which does not exceed the rate prescribed in the dividend provision in Article 10. According to this provision, profit-participating yield is classified according to the classification in the source state. If, accordingly, the source state classifies the profit-participating yield as dividends, this should also apply to the state of residence. Moreover, in some countries specific treaties or protocols thereto specifically indicate that income derived from PPLs is included in the concept of dividends.\(^{109}\)

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

The term 'dividends' as used in this Article means income from shares, 'jouissance' shares or 'jouissance' rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.\(^{110}\)

It is impossible to define the term 'fully and exhaustively' in view of the great differences between the laws of OECD Member countries.\(^{111}\)

The term 'interest' is defined in Article 11(3) of the OECD Model Tax Convention as:

Income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtors profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures.

This definition is in principle exhaustive.\(^{112}\) A reference to domestic law is not made, and the definition is considered autonomous.\(^{113}\)

Due to the potential difficulties of distinguishing between dividends and interest in cases of thin capitalization and to avoid any possibility of overlap between the categories of income dealt with in Articles 10 and 11, respectively, the term 'interest' as used in Article 11 does not include items of income dealt with under Article 10.\(^{114}\) The same should apply with regard to hybrid financial instruments even though this is not stated directly.\(^{115}\)

Accordingly, it should be analysed whether remuneration on PPLs in principle falls under the scope of Article 10 of the OECD Model Tax Convention, as this would lead to such remuneration not being covered by Article 11 of the OECD Model Tax Convention.

As a starting point profit-participating yield should not be considered dividend for tax treaty purposes. Article 10(3) of the OECD Model Tax Convention specifically mentions that the term 'dividends' requires that the income does not arise from instruments being debt claims. Article 10 encompasses jouissance rights, allowing the holder a right to the profits of the issuer without being a debt-claim. It is specifically mentioned in paragraph 24 to the OECD Commentary that the concept of dividends does not include debt-claims carrying a right to participate in the debtor's profits.

It is directly stated in Article 11(1) of the OECD Model Tax Convention that the notion of 'interest' includes income of debt-claims of any kind, whether or not carrying a right to participate in the debtor's profits. The provision contains no reference to domestic law of the contracting states.

In paragraph 18 of the OECD Commentary to Article 11 in the Model Tax Convention, it is stated that debt-claims and bonds, which carry a right to participate in the debtor's profits, are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest. In addition, paragraph 19 of the OECD Commentary to Article 11 is very clear. Here it is stated that:

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\(^{108}\) See Duncan, supra n. 2, 25, and A. Jones et al., *World Tax Journal* (2009), 5 et seq.

\(^{109}\) See for an overview of Dutch Tax treaties, E. Jansen & E. Kasteren, 'Hybrid Financial Instruments', DFI (2008), 185 et seq. and A. Jones et al., supra n. 108, 5 et seq. (at 44). German treaty practice including profit-participating yield as dividends is described in A. Jones et al., supra n. 108, 5 et seq. (at 45).


\(^{111}\) See para. 23 of the OECD Commentary to Art. 10(5).

\(^{112}\) See para. 23 of the OECD Commentary to Art. 11 and Baker, supra n. 110, 11–4, ma.no. 11B-68, Six, *Hybrid Finance and Double Taxation Treaties*, Bulletin (2009), 22 et seq.; Vogel, supra n. 4, 752, ma.no. 58; Vogel & Lehner, supra n. 110, 1009.

\(^{113}\) See OECD Commentary to Art. 11, para. 21 and Six, supra n. 112, 24; Schuch, supra n. 110, 229.

\(^{114}\) See OECD Commentary to Art. 11, Helminen, supra n. 110, 271, and the same in *European Taxation* (2004), 56 et seq. (58); Six, supra n. 112, 24.

\(^{115}\) However, in the 1987 OECD Report on thin capitalization, hybrid financial instruments are analysed under the overall heading of 'hidden equity' whereby it may be argued that the OECD has taken into account hybrid financial instruments with respect to the specific discussion of thin capitalization situations.
Interest on participating bonds should not normally be considered as a divided, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company (see "inter alia" paragraph 25 of the Commentary on Article 10).

In paragraph 25 to the OECD commentary on Article 10, the following is stated:

Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when repayment depends largely in the success or otherwise of the enterprise’s business.

As is seen, this refers to situations where the repayment as such depends on the success of the debtor company. This is generally not the case with respect to PPLs. Moreover, it is stated in paragraph 25 of the OECD commentary to Article 11 that the question of whether the contributor of a loan effectively shares the risks run by the debtor company should be determined in each individual case in the light of all the circumstances, as for example the following:116

- the loan very heavily outweighs any other contribution to the enterprise’s capital (or was taken out to replace a substantial proportion of capital which has been lost) and is substantially unmatched by redeemable assets;
- the creditor will share in any profits of the company;
- repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
- the level or payment of interest would depend on the profits of the company;
- the loan contract contains no fixed provisions for repayment by a definite date.

Based on the above interpretative material, different authors have identified different tests as being decisive in the context of delineation of yield from financial instruments. These tests will be applied in the following with respect to PPLs.

6.2. The Corporate Rights Test

The most essential part of the OECD Commentary with regard to hybrid financial instruments is paragraph 25 of the OECD Commentary to Article 10. Here it is stated that Article 10 not only deals with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, that is, when repayment depends largely on the success or otherwise of the enterprise’s business. The Commentary, however, does not fully clarify the scope of this statement.

When considering actual hybrid financial instruments, this test may be applied. According to Schuch, interpretative guidance can be found in the parallel interpretation of Article 7 of the OECD Model Tax Convention, regarding business income, which also requires a delimitation of the notion of business risk.117 Thus, business income under Article 7 should also be delimited against income from debt-claims under Article 11. The decisive factor in this assessment is the risk of the entrepreneur. Similar thoughts are expressed by Vogel, who states that the decisive points of view in terms of distinguishing dividends from interest are the same as those applying to the distinction between interest on the one hand and partners’ shares in profits on the other.118 A recipient of dividend has to accept an entrepreneurial risk corresponding to that of a regular shareholder. It is not sufficient that the risk is restricted to the claim to receive payment as is the case in profit-linked interest. The risk should correspond to what is accepted by a regular shareholder upon the contribution of share capital to the company, which also involves the risk of the possible total loss of the funds invested.119

The exact contents of the term ‘corporate rights’ as used in Article 10 of the OECD Model Tax Convention is not clear. An extensive analysis of this issue is provided by Avery Jones et al., in WTJ 2009, page 5 et seq. based on the historical context and development of the dividend article. The authors conclude that the term ‘other corporate rights’ is ambiguous and should be either clarified or deleted. Moreover, the authors conclude at page 27 that income from debt-claims cannot be included as ‘other corporate rights’.120 Finally, the authors conclude that the overlap between Article 10 and Article 11 should be solved by making clear that Article 11 does not include anything dealt with in Article 10.

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116 The Commentary is criticized by A. Jones et al., supra n. 108, 40, pointing out that the Commentary attempts to draw an artificial dividing line between debt and equity and that there is a continuum of the kinds of instruments that companies issue with varying attributes of risk and return, but it is impossible to pick some point on that continuum where a relevant line should be drawn for tax policy. Further, it is stated that every unsecured lender shares the risk of success or otherwise of the borrower’s business. Moreover, it is stated that the listed factors do not always indicate risk sharing, as with property companies and banks where it is normal to have debt that heavily outweighs the capital.

117 See Schuch, supra n. 110, 225.

118 See Vogel, supra n. 4, 651, n. no. 189; Vogel & Lehnert, supra n. 110, 919, n. no. 189.

119 See Vogel, supra n. 4, 651, n. no. 189; Vogel & Lehnert, supra n. 110, 919, n. no. 189; and supportive Helminen, supra n. 110, 273.

120 The conclusion is, however, modified in the sense that while in principle debt-claims are not corporate rights in the sense of membership rights, this does not exclude the possibility that domestic non-tax law treats excessive debt in a thin capitalization case as a membership right rather than debt, 29.
Nevertheless, certain criteria for the classification of corporate rights are generally derived by authoritative authors. The most important criterion is the right to benefit from a possible increase in the value of the company’s assets as remuneration for sharing the risk run by the enterprise. The term ‘corporate rights’ should not be interpreted in its narrow sense, that is, requiring that the holder would have to be entitled to the full rights of a regular shareholder, including voting rights and control rights over the company. According to leading commentators, the notion of corporate rights includes a second criterion besides the above-mentioned. The second criterion is that the holder of corporate rights must at least be entitled to participate in the liquidation proceeds of the company. This is fulfilled if the holder participates in the hidden reserves of the issuing company. Moreover, this means that the repayment to the holder has to be subordinated to the claims of other creditors. Based on this Vogel summarizes the requirements for a corporate right to exist in (1) the title to carry a share in current profits and (2) to at least a share in the liquidation proceeds (i.e., the hidden reserves).

The wording of Article 10 of the OECD Model Tax Convention, however, does not explicitly list these criteria or go into detail on how these two criteria have to be formulated in order for a specific hybrid financial instrument to qualify as a dividend-generating instrument (equity). The wide scope of possible characteristics of hybrid instruments consequently makes it difficult to decide whether the two criteria mentioned above are fulfilled. Whether or not the extent of the profit participation and the extent of the participation in the liquidation proceeds combined impart enough participation in the entrepreneurial risk to allow for qualification of the financial instrument as a corporate right must therefore be evaluated in each individual case in light of all the characteristics and circumstances of the financial instrument in question. Only under the fulfilment of this test will the investment qualify as equity and thus as being dividend-generating from a tax treaty perspective.

Therefore, according to the Corporate Rights Test a hybrid financial instrument with a profit-participating right as well as a right to participate in the liquidation proceeds of the issuing company does not yield income from debt-claims in terms of Article 11(3) of the OECD Model Tax Convention, because the terms ‘income from corporate rights’ and ‘income from debt-claims’ with respect to tax treaties are mutually exclusive. Therefore, from a treaty perspective, such instruments generate income from corporate rights (dividends) under Article 10(5) rather than interest income under Article 11(5). If on the other hand, however, the instrument only meets one of the two criteria set up above, the yield should not be considered dividends but rather interest income under Article 11(5).

Applied to PPL instruments, it is clear that participation in the debtor’s profits alone does not make a debt-claim a dividend-generating right. It is, however, not excluded on the above basis that income from a PPL instrument is treated as dividend if other equity characteristics are present, that is, loss-participation and participation in liquidation proceeds.

### 6.3. The Debt-Claim Test

It has been argued in international commentary that the decisive factor in distinguishing dividends from interests is not the corporate rights test presented above but more correctly should be whether a right to redemption exists and similarly whether a real debt-claim exists.

The term ‘debt-claims of every kind’ as used in Article 11 of the OECD Model Tax Convention is not defined. According to the OECD Commentary, the definition, however, obviously embraces cash deposits and security in the form of money, as well as bonds and debentures.
The enumerations should be seen as exemplary and do not influence the universal character of the definition itself. Generally, the term ‘debt-claims’ should moreover be understood in its broadest sense. Generally, ‘interest’ under Article 11 includes all the issuer pays over and above the amount paid by the subscriber, that is, interest accruing plus any premium paid at the redemption or at issue. More generally, it may be said that interest encompasses remunerations for making capital available to the debtor.

There is no interest in the absence of an underlying claim. Accordingly, the existence of a claim is a condition sine qua non with regard to interest classification for tax treaty purposes. Seemingly, the notion of a debt-claim should be understood in accordance with private law. This i.a. requires that there are at least two separate taxable entities involved. This can be concluded to be the case with regard to the treaty definition of a debt-claim.

In a comprehensive analysis of the classification of reverse convertibles, Rotondaro has analysed the notion of ‘interest’ as applied in Article 11(3) of the OECD Model Tax Convention. Rotondaro argues that the existence of an absolute and unconditional right to redemption is to be regarded as the basic feature of the debt-claims giving rise to interest under Article 11 of the OECD Model Tax Convention. The author states that, irrespective of the fact that uncertainty is present in an instrument regarding the yield, this does not exclude interest classification under the tax treaties; the opposite conclusion is to be made regarding uncertainty as concerns the redemption of the principal. Following this view there can only be interest under Article 11 when the lender has a certain and unconditional right to the repayment of the face value of the credit. The author derives this conclusion from OECD Commentary (paragraph 19 regarding Article 11) making use of the word ‘repayment’ as well as the international tax literature, also making use of the word ‘repayment’.

Moreover, Rotondaro supports his arguments by pointing towards system of the OECD Model Tax Convention regarding passive income characterization and allocation of the taxing rights. This system calls in the view of the author for a limitation of the scope of the interest article to only include income arising from contracts attributing to the investor an unconditional and certain right to redemption of the face value. It is stated that the existence/non-existence of an unconditional and certain right to redemption is the only effective and correct criterion available for the purpose of distinguishing between interest and dividend under tax treaties. With reference to the broad nature of the concept of dividends, it is stated that cross-border passive income items are not required to arise from underlying instruments, which entitle their holder to the typical rights and powers of the shareholder (i.a. a right to liquidation proceeds, membership of the shareholder meetings, voting rights, etc.). Moreover, it is stated that counterparties of a company can be regarded as receiving dividend payments, to the extent that the contract (1) carries a right to participate in the company’s profits; and (2) is not a debt-claim. Based on this Rotondaro concludes that neither the entitlement/non-entitlement to the mentioned rights and powers nor the profit-participating character of the instrument can be used as criteria in order to distinguish between interest-yielding instruments on the one hand and dividend-yielding instruments on the other hand.

According to Rotondaro, the only workable distinctive criterion left between the scope of Article 10 and the

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134 See Sin., supra n. 112, 6.
135 See Vogel, supra n. 110, 732, ma.no. 59; Vogel & Lehner, supra n. 110, 1009, ma.no. 5/9a.
136 See para. 20 of the OECD Commentary to Art. 11.
137 See, e.g., Vogel, supra n. 110, 731, ma.no. 56; Vogel & Lehner, supra n. 110, 1008, ma.no. 56; Lang, supra n. 110, 96; Schuch, supra n. 110, 229; Sin, supra n. 110, 24. Vogel’s definition is further developed, supra n. 110, 734, ma.no. 60. ‘… Interest is no more than the remuneration received for making capital available subject to repayment, and does not include any other way in the hazards of the borrower’s business …’. In its decision, the Supreme Court of Canada (Her Majesty the Queen, Appellant v. Melford Developments Inc. Respondent 1982 Carwell Law. 209, [1982] 2 S.C.R. 504, 44 N.R., 139 D.L.R. (3d) 577, 82 D.T.C. 6281), found in the Melford case that interest with regard to the Canada-Germany DTC was the remuneration received by the lender in exchange for allowing the borrower to make use of the principal. See Rotondaro, DFI (2000), 264, for a summary of the case.
138 See Vogel, supra n. 110, and Schuch, supra n. 110, 228.
139 See Schuch, supra n. 110, 229.
140 See Art. 116(6) of the OECD Model Tax Convention referring to the ‘payer’ and to the ‘beneficial owner’ and for commentary Schuch, supra n. 110, 229. This interpretation clearly affects loans to partnerships.
131 See DFI 2080, 258 et seq.
142 Ibid., 264.
143 Ibid., 265.
144 It can be objected that the sources said to support the point of view do not deal specifically with the issue. When para. 19 of the OECD Commentary mentions repayment, this is used to illustrate when an interest payment may be classed as dividend, that is, when the profit participating bonds effectively share the risk run by the debtor company.
145 Ibid.
146 Ibid., 265.
147 Ibid., 266.
scope of Article 11 lies in the debt-claim character of the underlying receivable. The analysis should be carried out regarding the contract giving rise to the payments, or put another way: the source of the payments. The author finds that the use of the word ‘repayment’ in paragraph 25 of the OECD Commentary to Article 10 should be seen as the final verification of the view that repayment certainty is a condition sine qua non with regard to interest classification and thus with regard to interest-dividend demarcation. The statement in paragraph 19 of the OECD Commentary to Article 11, according to which interest on convertible bonds fall within the scope of Article 11 until the time of conversion is said to be based on the certainty/uncertainty of the investor’s entitlement to redemption.

The view of Rotondaro has recently been supported by Fehér. The author states that the term ‘corporate rights’ should not be relied on as the primary distinction between dividends and interest, and that the term ‘debt-claim’ seems more suitable for this purpose. As Article 11 of the OECD Model Tax Convention should be interpreted autonomously, the term ‘debt-claim’ should be developed further. Fehér provides the following attributes that distinguish between interest and dividends possible:

(a) A claim should involve a legally enforceable claim (rather than the term recommended by Rotondaro: ‘absolute and unconditional right to redemption’).
(b) The amount and calculation of the yield do not have to reflect a ‘classic’ debt (fixed rates).
(c) It is not necessary that the claim is secured or that it ranks before the claims of others. However, in the case of subordination, the interest should reflect the greater risks involved.
(d) The claim should be genuine, not only from a legal but also from an economic perspective.
(e) The economic risks involved should generally reflect those of a ‘debt-claim’ and not those of ‘equity’.

The arguments presented above may also affect the treatment of PPLs under tax treaties. Basically, the relevant analysis is whether PPL instruments can be said to hold an unconditional and certain right to redemption or not, and if a PPL instrument does not express a claim in accordance with private law. Based on this, in our opinion, pure PPL instruments should be considered debt and the yield thereof interest for tax treaty purposes.

Clearly, it cannot be foreseen how this question will be solved by Courts of different states. Accordingly, a uniform understanding of whether this test should replace the corporate test should hardly be expected on a global level.

In conclusion, remuneration on pure PPL instruments should not be regarded as dividends from a tax treaty perspective and should be considered interest payments according to Article 11 of the OECD Model Tax Convention. Of course, this conclusion depends on the fact pattern involved and on whether domestic treaty practises will to another treatment.

7. Conclusion and Perspectives

PPL are widely used in international corporate financing. Seemingly, the use of PPLs is increasing. The tax law classification and treatment of PPLs is of great importance when considering issuing or investing in such instruments. From a policy perspective, the present analysis is based on the fundamental position that the tax law treatment of PPLs should be in accordance with the principle of tax neutrality compared to other financing alternatives.

The article has provided insight into the design of PPLs and the financial reasoning behind the issuance of PPLs. With the purpose of introducing the variations of domestic law, the article has presented federal US and German tax law classification of PPLs. Moreover, the article has provided an in-depth analysis of the domestic tax law classification and treatment of PPLs in Danish tax law. This analysis has shown that the situation is far from being acceptable due to the applied method of calculating the deductible loss for tax purposes for the issuing company.

From the perspective of EU law, the scope of the IRD specifically addresses PPLs in the wording of Article 4 of the Directive. Based on this Member States seem to have fairly good possibilities to exclude PPLs from the scope of the IRD. However, good arguments can be presented that profit-participating yield falling outside the scope of the IRD should instead enjoy the benefits of the PSD. This issue is not finally clarified and may consequently result in uncertainty.

The article has also presented the possible treatment of PPLs according to double tax treaties. It is concluded that remuneration on pure PPL instruments cannot be regarded as dividends from a tax treaty perspective and should be considered interest payments according to Article 11 of the OECD Model Tax Convention. This conclusion depends on the fact pattern involved and on whether domestic treaty practises will reach to another treatment.

Notes

148 Ibid., 266.
149 Ibid., 267 and Lang, supra n. 110, 145.
150 See Fehér, supra n. 110, 227 et seq. (242 et seq.).
151 Ibid., 245.
152 See to this effect Schuch, supra n. 110, 235 and Vogel & Lehner, supra n. 110, 1012, ma.no. 64.