

# Perpetual and Super-Maturity Debt Instruments in International Tax Law

**Authoritative treatise addressing the tax classification and tax treatment of perpetual debt instruments and super-maturity debt instruments. In order to analyse the tax aspects of perpetual debt and super-maturity debt, the background regarding commercial, rating, regulatory and accounting issues is provided. Although the main focus of the article is on the tax classification of perpetual debt and super-maturity debt under domestic law, EU corporate law directives and income tax treaties; the treatment under domestic law is illustrated by US, German and Danish law. More specifically, the article considers the economic and legal framework, followed by a comparative overview of tax law classification in the United States and Germany and gives an analysis of the tax classification and treatment under Danish tax law. Next, the article analyses whether payments under perpetual debt and super-maturity debt instruments fall under the scope of the EU corporate tax directives, and also considers the income tax treaty protection of payments under perpetual and super-maturity instruments.**

## 1. Introduction

Financial innovation has increased dramatically during the past 30 years or so. The international financial market has changed dramatically too, and is likely to continue to do so.<sup>1</sup> A vast number of financial products have been developed for the use of financial institutions and companies as a product of the financial innovation.<sup>2</sup> The development, which began in the 1980s, has been described as a "mutation" of financial products.<sup>3</sup>

Traditionally, European companies have been rather conservative regarding the use of financing sources. It is a fact that straight debt from banks and the issuance of share capital have been the preferred sources of financing.<sup>4</sup> Hybrid financial instruments really took off on the European markets with financial institutions at the time the euro was introduced, and this market has been growing ever since.<sup>5</sup> However, it has been relatively unusual for non-financial companies to issue such hybrid capital. In 2005, this changed dramatically, resulting in a massive use of hybrid financial instruments issued by companies outside the financial sector. This change seems to have been triggered by a more uniform approach by rating agencies assessing the effect of hybrid issuance.<sup>6</sup>

Examples of hybrid financial instruments are perpetual debt and super-maturity debt. The features of such instruments may be illustrated by reference to two well-

known recent issues in Europe:<sup>7</sup> Dansk Olie og Naturgas (Danish Oil and Natural Gas, DONG) and Vattenfall. The DONG hybrid issuance dated 21 June 2005 amounted to EUR 1.1 billion.<sup>8</sup> As background information regarding the issuance, DONG has stated: "On 21 June DONG issued a bond loan and hybrid capital in the European capital market. The issuing of hybrid capital strengthens DONG's capital base and will, combined with the bond capital, be used to fund DONG's recent investments and acquisitions."<sup>9</sup>

The hybrid loan in this issue is subordinated and has an ultra-long maturity of 1,000 years. The hybrid loan features a built-in step-up coupon after ten years, a so-called "non-call ten step-up hybrid". The coupon for the first ten years is fixed at 5.5%, with the result that it becomes floating with a step-up added. As a result of the permanent and subordinated nature of the loan, it is treated by the rating agencies as 50% equity and 50% interest-bearing debt. The loan is accounted for as equity. Consequently, it is not included in the statement of net interest-bearing debt under financial highlights, and the annual interest payments are included in the cash flow statement (financing activities) instead of in the income statement, in the same way as dividend payments. The instrument is treated as debt for tax purposes.

Another large issuance in 2005 was by Vattenfall on 27 June 2005. There are obvious similarities between the two

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\* Associate Professor, PhD, Copenhagen Business School; Partner, Deloitte. This article is based on research conducted while the author was a Visiting Scholar at Stanford Law School in 2007.

1. See Giddy, "Global Financial Markets", <http://giddy.ord/db/structured/gfmc17.htm>.

2. See Schlunk, *Texas Law Review* (2002), at 859, 861-862, stating that theoretically, there is no limit to the number of new instruments that can be created from deconstruction and reconstruction of debt and equity instruments. Accordingly, there is no theoretical limit to the number of new instruments that can be created in an attempt to exploit the inconsistency in the tax treatment of corporate debt and equity. In the view of Schlunk, the debt-equity distinction will be eliminated as a result of taxpayers' actions, as financial innovation becomes cheaper and cheaper, the distinction will be exploitable by taxpayers to such an extent that their choice of tax treatment will be effectively elective.

3. See Giddy, note 1; Hariton, *Tax Law Review* (1994), at 499; Wood, *Canadian Tax Journal* (1999), at 49 et seq.

4. See SEC(2001) 1667; Rapport fra Børsrådgiverforeningen: Nye skridt på det danske obligationsmarked (1999), at 17.

5. See Euromoney, *The Guide to Hybrid Capital* (2006), at 2.

6. See Euromoney, *The Guide to Hybrid Capital* (2006), at 10; Amin, *Hybrid Capital – A Simple Introduction* (2006), at 3.

7. For an overview of other large issues, see Häuselmann, *Betriebs-Berater* 2007/17, at 931, fn. 1.

8. See the quarterly announcement from Q2 2005, available at [http://www.dongenergy.com/NR/rdonlyres/EB880458-DFE9-4C04-9947-9070017BD5CD/0/050830\\_Kvartalsmeddelelse\\_2005\\_Q2\\_Presse\\_UK.pdf](http://www.dongenergy.com/NR/rdonlyres/EB880458-DFE9-4C04-9947-9070017BD5CD/0/050830_Kvartalsmeddelelse_2005_Q2_Presse_UK.pdf).

9. Id.

issuances. Vattenfall Treasury AB was the issuer, and a guarantee was provided by Vattenfall AB.<sup>10</sup> The issuance amounted to EUR 1 billion of perpetual bonds with no fixed maturity date. The bonds were rated 75% equity credit by Moody's and 60% by Standard & Poor's (S&P). There is a fixed interest of 5.25% for the first ten years, thereafter EURIBOR 3m + 2.95%. The issue contained replacement language with the following wording: "It is the intention of the Issuer and the Guarantor that the Capital Securities will constitute a permanent component of the Guarantor's consolidated capital ...". Relevant features of the bonds include:

- compulsory interest payment date. Interest must be paid if during the preceding year (1) the guarantor has paid a dividend or made any other payment relating to share capital or (2) the issuer or guarantor has made any payment relating to equivalent bonds;
- mandatory non-payment date. Interest must not be paid if the interest cover ratio according to the latest annual account is less than or equal to 2.5; and
- cumulative optional interest deferral. On any other interest payment date, the issuer may at its discretion elect to defer interest in whole or in part. Deferred interest is accumulated. For a 12-month period after any mandatory non-payment date, the guarantor "to the fullest extent permitted by any applicable laws" will not (1) propose to its shareholders and "will otherwise act to prevent" the declaration of payment of dividends or (2) redeem or repurchase shares. Both bonds and guarantee are deeply subordinated.

A comparison between DONG and Vattenfall reveals the following differences:

- 1,000 years instead of perpetual;
- subordination *pari passu* with other subordinated debt instead of ranking behind other subordinated debt;
- no "intention" in DONG regarding issuance of more junior debt;
- no "compulsory interest payment date" or "mandatory non-payment date" in DONG. The issuer may elect to defer interest at any time;
- in DONG, deferred interest is accumulated and must be satisfied before any dividend is paid;
- in DONG, deferred interest may be satisfied only through issuance of shares, same securities or similar securities;
- optional redemption possible after five years instead of ten years; and
- non-payment of interest may trigger bankruptcy application (in Denmark but not elsewhere).

These two cases illustrate that publicly owned companies that are not able to raise capital by way of public issuance of shares may benefit from equity-like debt instruments such as perpetual debt and super-maturity debt.

The tax classification and tax treatment of perpetual debt instruments and super-maturity debt instruments are the subject of this article. In order to analyse the tax aspects of perpetual debt and super-maturity debt, back-

ground regarding commercial, rating, regulatory and accounting issues is provided. The main focus is the tax classification of perpetual debt and super-maturity debt under domestic law, EU corporate law directives and income tax treaties. The treatment under domestic law is illustrated by US law, German law and Danish law, with an obvious emphasis on Danish law (given the nationality of the author). Moreover, the classification under EU corporate tax directives and income tax treaties is analysed.

This article will consider the economic and legal framework, followed by a comparative overview of tax law classification in the United States and Germany, and will analyse the tax classification and treatment under Danish tax law. In addition, this article will analyse whether payments under perpetual debt and super-maturity debt instruments fall under the scope of the EU corporate tax directives, and also considers the income tax treaty protection of payments under perpetual and super-maturity instruments.

## 2. Economic and Legal Framework

### 2.1. In general

The maturity of bonds/loans is an important factor for rating and regulatory purposes. Accordingly, instruments with long-term maturity (super-maturity loans) or even perpetuity have been issued widely for some time.<sup>11</sup> Apparently, perpetual instruments seldom turn out to be particularly long lived, in spite of their *ex ante* infinite horizon.<sup>12</sup> The holder of super-maturity and perpetual instruments will typically receive ongoing payments. The super-maturity and perpetuity features are often combined with other equity features such as profit participation, subordination and interest deferral. The desire for financial flexibility while maintaining the permanency of perpetuities are resolved in the markets by embedding most perpetual securities with an issuer's call option, typically exercisable ten years from the date of issue.<sup>13</sup>

Chan et al. have analysed the motivations for issuing super-maturity instruments in the specific form of century bonds (i.e. bonds with a maturity of 100 years) by looking at financial theories that explain companies' choice of debt maturity.<sup>14</sup> According to the author's financial research, it is suggested that companies have incentives to issue debt with longer maturity when liquidity risks and information asymmetry are low.<sup>15</sup>

10. For the following summary, see the presentation by André Andersson at the Nordic Capital Markets Forum on 26 October 2006.

11. The global market for outstanding large perpetual debt instruments amounted to USD 260 billion in 2005. See Mjos and Persson, "Callable Risky Perpetual Debt: Options, Pricing and Bankruptcy Implications" (23 December 2005), NHH Dept. of Finance and Management Science Discussion Paper 22/2005, at 1, available at SSRN, <http://ssrn.com/abstract=676687>.

12. *Id.* at 1.

13. *Id.* at 3.

14. See Chan and Viswanath, "Century Bonds: Issuance Motivations and Debt versus Equity Characteristics" (2002), available at [http://webpage.pace.edu/pviswanath/research/papers/kamchan\\_final\\_version\\_102303.pdf](http://webpage.pace.edu/pviswanath/research/papers/kamchan_final_version_102303.pdf).

15. *Id.* at 5.

On the basis of empirical observations (market value of equity and capitalization), it is suggested that large companies with lower liquidity risk and information asymmetry are more likely to issue debt with long maturity.<sup>16</sup> Moreover, financial theory suggests that companies with high agency costs of debt have more incentives to issue short-term debt to minimize the financing costs, and that companies with low growth opportunities have low agency costs of debt because the managers of these companies have less flexibility in terms of investment decisions.<sup>17</sup> It is suggested that companies with low growth opportunity and agency costs of debt tend to issue long-term debt.<sup>18</sup> Finally, the tax benefit is analysed, as the tax benefit is often suggested as one of the major reasons for companies to issue long-term debt. Companies with greater expected benefits from debt tax shields have more incentive to issue debt with longer maturity.<sup>19</sup> On the basis of reviewing the average tax expense ratio, however, the authors concluded that there is little support for the argument that long-term debt is primarily chosen to evade corporate taxes.<sup>20</sup>

**2.2. Regulatory framework**

For regulatory purposes, the maturity of bonds plays a significant role in solvency requirements for financial institutions. The financial sector has issued what is referred to as “innovative Tier 1 capital” since the late 1990s. Even more attention is expected due to the Basel II accord<sup>21</sup> and the EU Solvency II project.<sup>22</sup>

In order to ensure consistent application of the Basel II framework, the European Union has set out new own-funds requirements for banks and credit institutions.<sup>23</sup> Under Art. 63(2) of Directive 2006/49/EC, securities of indeterminate duration and other instruments that fulfil the following conditions may also be accepted as “other items” in terms of defining the own-funds of an institution:

- they may not be reimbursed on the bearer’s initiative or without the prior agreement of the competent authority;
- the debt agreement must provide for the credit institution to have the option of deferring the payment of interest on the debt;
- the lender’s claim on the credit institution must be wholly subordinated to those of all non-subordinated creditors;
- the documents governing the issuance of the securities must provide for debt and unpaid interest to be such as to absorb losses, while leaving the credit institution in a position to continue trading; and
- only fully paid-up amounts may be taken into account.

Based on the former Directive 2000/12/EC, the Danish legislation on financial institutions – as an example – contains special rules regarding hybrid Tier 1 capital.<sup>24</sup> Under this provision, hybrid instruments are considered “own capital” for financial institutions within an upper limit of 15% of the total Tier 1 capital. The conditions to be met are as follows:

- the amount must be paid to the financial institution;
- the debt instrument must be of an indeterminate duration;
- the debt may be reimbursed only if the financial institution is liquidated or bankrupt;
- the debt must be reimbursed on the initiative of the financial institution, and not earlier than ten years after being paid in;
- the lender’s claim on the financial institution must be wholly subordinated to those of all non-subordinated creditors;
- the lender’s claim on the financial institution may not be secured by other financial institutions or in any other way ensured priority over other creditors of the institution;
- the obligation to pay interests is repealed if the financial institution does not have sufficient financial reserves according to the most recent financial statements;
- the interest rate should not be altered due to the lender’s assessment of the financial institution;
- the debt agreement must provide for the financial institution to have the option of deferring the payment of interest on the debt if the Tier 1 capital at maturity does not exceed the capital requirement;
- deferred interest payments may fall due only if the capital requirement is observed;
- the supreme body of the financial institution must be able to write down the hybrid Tier 1 capital and deferred interest payments if own-funds (the equity) are lost;
- the governing contracts may not provide for an increased interest above certain factors;
- the governing contracts may not provide for more than one increase of the interest; and
- an increased interest may not commence less than ten years from the issue.

**2.3. Rating framework**

Hybrid capital is relevant in order to ensure creditworthiness of the company expressed by a credit rating prepared by the credit rating agencies (S&P, Moody’s, Finch).<sup>25</sup> If a company issues debt publicly, its credit rating might be marked down, increasing its effective bor-

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16. Id. at 6.  
 17. Id.  
 18. Id.  
 19. Id.  
 20. Id.  
 21. See Basel II, “International Convergence of Capital Measurement and Capital Standards. A Revised Framework” (2005).  
 22. See e.g. COM(2008) 119 final, Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (SOLVENCY II).  
 23. See Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking-up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.  
 24. Sec. 132 Act on Financial Business, as introduced by Act 428 of 6 June 2002 (L 176).  
 25. Humphreys, *PLI/Tax* (2006), at 432 et seq.

rowing cost.<sup>26</sup> Replacing senior debt with hybrid capital can allow a company to de-lever, effectively decreasing net debt by the amount of equity credit attributed to the hybrid financial instrument, thereby improving the company's credit profile.<sup>27</sup> Compared to straight debt security, it may not be needed in order to obtain the financing needed if provided by way of hybrid financing.<sup>28</sup> Rating agencies have been evaluating hybrid financial instruments for many years. Most recently, the major rating agencies have sought to clarify their treatment of hybrids, and have made their rating criteria more objective. This is apparently a response to the constant drumbeat of pressure from issuers and investment bankers that are trying to plan their hybrid transactions with certainty.<sup>29</sup>

Some rating agencies operate with debt-equity continuums, and place hybrids within this frame.<sup>30</sup> At the one end of the continuum in Category A, pure debt is found, classified as 0% equity and 100% debt. Category B is classified as 25% equity and 75% debt; Category C is classified as 50% equity and 50% debt; and Category D is classified as 75% equity and 25% debt. Finally, category E is classified as 100% equity and 0% debt.<sup>31</sup> It is then possible to place different hybrid instruments in the various categories.<sup>32</sup> The Moody's change in methodology is considered revolutionary, as the historical criteria were based solely on features found in equity,<sup>33</sup> namely no maturity, no ongoing payments and loss absorption.<sup>34</sup> The other rating agencies have since followed. Accordingly, corporations are attracted to perpetual and super-maturity debt instruments because of an increasing awareness of the rating impact of debt financing, and hence the cost of financing. The use of perpetual and super-maturity debt may improve or maintain the existing credit rating.

#### 2.4. Financial accounting framework

For financial accounting purposes, perpetual instruments may be considered a liability, equity or a compound instrument (including both categories) under IAS 32 and IAS 39. The idea from the perspective of the issuing company is often to obtain equity treatment for accounting purposes. Under IAS 32.11, an equity instrument is any contract that evidences a residual interest in the assets of an entity after deduction of all its assets. The critical feature in differentiating a financial liability from an equity instrument is that a financial liability contains a contractual obligation requiring the transfer of cash or another financial asset or an exchange of financial instruments under conditions that are potentially unfavourable, whereas an equity instrument does not contractually obligate the issuer to transfer cash or other financial instruments, but merely evidences a residual interest in the assets of the enterprise.<sup>35</sup> In IAS 32 AG6, the following is stated regarding perpetual debt instruments:

Perpetual debt instruments (such as 'perpetual' bonds, debentures and capital notes) normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the

future. For example, an entity may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8 percent applied to a stated par or principal amount of CU1,000.\* Assuming 8 percent to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of CU1,000 on initial recognition. The holder and issuer of the instrument have a financial asset and a financial liability, respectively.

Accordingly, the accounting classification of perpetuals and super-maturity instruments depends on whether interest payment is at the discretion of the issuer. If worded correctly, an instrument that combines the absence of maturity with the absence of interest payments or postpones the interest payments may be classified as equity under IFRS.<sup>36</sup>

### 3. Classification and Treatment under Domestic Tax Laws

#### 3.1. In general

From an overall perspective, hybrid financial instruments give rise to several tax law issues. The same is true regarding perpetual debt and super-maturity debt instruments. The classification and treatment of such instruments may be uncertain from the perspective of domestic tax law. Obviously, even more uncertainty or tax planning opportunities may arise in cross-border transactions where domestic classification principles of more than one jurisdiction are applied. The domestic tax law treatment of perpetuals and super-maturity instruments is analysed below. Initially, a comparative view is provided by looking at the classification in the United States and in Germany, followed by a more comprehensive analysis of Danish law on the subject.

#### 3.2. US federal tax law

In attaching different tax consequences to debt (e.g. interest deductibility) as compared to equity (e.g. divi-

26. Amin, note 6, at 2.

27. Euromoney, *The Guide to Hybrid Capital* (2006), at 9.

28. Leitinger, in *Hybride Finanzierungsinstrumente – Alternative zur traditionellen kreditfinanzierung*, Bischof and Eberhartinger (eds.) (2005), at 50.

29. See Humphreys, note 25, at 425 et seq.

30. New Instruments Standing Committee, Moody's Investor Service, "Moody's Tool Kit: Evolutionary not Revolutionary!" (February 2005); Fitch Ratings, "Equity Credit for Hybrids and Other Capital Securities" (27 September 2006).

31. Standard & Poor's has also been forced to clarify its rating criteria. S&P ranks hybrid instruments in three categories: Category 1, High Equity Content; Category 2, Intermediate Equity Content (divided into two levels, strong and adequate); and Category 3, Minimal Equity Content. See in detail Standard & Poor's Commentary Report, "Equity Credit for Bank and Insurance Hybrid Capital, A Global Perspective" (2006); Humphreys, note 25, at 432 et seq.

32. A specific range of hybrid financial instruments is actually referred to as "Basket D Instruments". See Freeman, Stevens and Hollender, 734 PLI/Tax (2006), at 895-896.

33. See Humphreys, note 25, at 427.

34. Fitch Ratings, note 30, at 3, specifying the following features that a security must demonstrate in order to qualify for equity consideration: (1) loss absorption in relation to senior creditors through subordination, along with the ability to avoid ongoing cash payments without triggering a default or (2) mandatory conversion to an equity instrument.

35. See IAS 32.16-17.

36. See also Brokamp and Hölzer, *Die Finanz-Rundschau* 2006/6, at 272, 274.

dends 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.<sup>37</sup> Under US law, classic 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 ...."<sup>38</sup> An identical wording is used in some specific tax law provisions, e.g. Sec. 385(b)(1).<sup>39</sup> Debt cannot exist if there is no enforceable obligation. The existence of such an obligation is determined on the basis of applicable local or state law (common law).<sup>40</sup> 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 ...."<sup>41</sup>

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 perpetual debt instruments.

Under US federal tax law, a fixed maturity date is considered a *conditio sine qua non* to obtain debt classification by some courts.<sup>42</sup> In *Monon Railroad v. Commissioner*,<sup>43</sup> a 50-year term was respected. Although the Internal Revenue Service (IRS) cautioned in Notice 94-47 that a less-than-50-year term to maturity should not be relied upon as presumptive indicia of indebtedness, many authorities have found indebtedness in even longer-dated instruments.<sup>44</sup> A fixed maturity date is considered virtually essential to debt classification, but is not necessarily sufficient alone.<sup>45</sup> Moreover, the absence of a maturity date has been held to indicate equity.<sup>46</sup> On the other hand, although a fixed maturity date appears to be essential to a finding that an instrument constitutes debt, the presence of a fixed maturity date clearly does not by itself preclude an instrument with such a feature from being treated as equity.<sup>47</sup> It is recognized that preferred stock may be subject to mandatory redemption at specified times. Based on this, it may be stated that the absence of a fixed maturity date is more damaging to debt classification than the presence of such a date is favourable. A maturity date indicates the time when the creditor is unconditionally entitled to require payment of principal.<sup>48</sup> The absence of a maturity date does not preclude debt treatment if control over repayment is in the hands of the creditor, as with demand loans and open account transactions.<sup>49</sup>

Moreover, the maturity date must not be too far in the future.<sup>50</sup> A shorter period of time between issuance and the maturity/redemption is more clearly indicative of debt. The greater the risk of default when the date of reckoning arrives, the more the "creditor" is locked into the corporation's fortunes like a shareholder. No specific period can be said to exist under US case law.<sup>51</sup> What is

"reasonable" will vary with the circumstances of the particular business.<sup>52</sup> In Notice 94-47, the IRS stated that it would scrutinize instruments with "unreasonable long maturities". What is considered an unreasonable long maturity depends on all the facts and circumstances, including the nature of the enterprise issuing the security. In this context it is well known that several companies, including Walt Disney Company and Coca-Cola Company, have issued 100-year term instruments.<sup>53</sup>

In some cases courts have tested long-dated debt instruments by inquiring whether the obligor will be around at the time the debt matures. As stated by Humphreys, this

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37. See Bittker and Eustice, *Federal Taxation of Corporations and Shareholders* (2006), at 4-12.

38. See *Gilbert v. Commission*, 248 F2d 399 (2d Cir. 1957).

39. See Treas. Reg. Sec. 1.165-5(a)(3), requiring an evidence of indebtedness to contain the right to pay a fixed or determinable sum of money. The IRC contains a nearly circular definition of "debt instrument" in Sec. 1275(a)(1)(A), which provides that the term "debt instrument" means a bond, debenture, note or certificate or other evidence of indebtedness. Garlock, *Federal Income Taxation of Debt Instruments* (2006), at 1004, defines indebtedness as generally arising when one party transfers money to another in exchange of a binding legal obligation to repay the sum transferred, either on a date certain or on demand.

40. See Garlock, note 39, at 1008.

41. See *United States v. Title Guarantee & Trust Co.*, 133 F2d 990 (6th Cir. 1943); *O.P.P. Holding Corp.*, 76 F2d 11 (2d Cir. 1935).

42. See e.g. *United States v. South Georgia Ry Co.*, 107 F2d 3 (5th Cir. 1939); *Jewel Tea Co. v. United States*, 90 F2d 451 (2d Cir. 1937). In *Laidlaw Transportation, Inc.*, 75 T.C. Memo, the Tax Court held that advances to related corporations were equity where the taxpayer had continuously extended and never enforced loan maturity dates.

43. 55 TC Memo, 345 (1970).

44. See Freeman, Stevens and Hollender, note 32, at 896-897; *Ruspyn Corp. v. Commissioner*, 18 TC Memo 769 (1952) (89-year debt); *Mayerson v. Commissioner*, 47 T.C. Memo 340 (1966) (99-year debt); *Helvering v. Richmond*, 90 F2d 971 (1937) (indefinite maturity).

45. See Bittker and Eustice, note 37, at 4-25; Berman and Strain, *Cahiers de Droit Fiscal International*, 2000a, at 672; Buriilovich, *The Tax Adviser* (1 December 2006), at 2; Hammer, *Derivatives and Financial Instruments* (1999), at 337; Garlock, note 39, at 1018 et seq. Moreover in general on the criterion, see Wiedermann-Ondrej, *Hybride Finanzierungsinstrumente in der nationalen und internationalen Besteuerung der USA* (2007), at 247 et seq.

46. See *Ambassador Apartments Inc.*, 50 TC 236 (1968); *Kathryn Fuscaldo*, 267 F Supp 2d 442 (ED PA 2001).

47. See *Commissioner v. Meridan & Thirteenth Realty Co.*, 132 F2d 182 (7th Cir. 1942) where the Court held that an instrument denominated as preferred stock was equity despite the presence of a fixed maturity date. In line with this result is IRS Rev. Rul. 78-142, 1978-1 CB 111, where it was concluded that a mandatory redemption feature does not preclude an instrument from being treated as equity. More precisely, the IRS implicitly treated mandatorily redeemable preferred stock as equity. See Garlock, note 39, at 1019. Plumb considers this factor the most important of the formal factors used by courts, but at the same time states that the presence of a maturity date does not guarantee recognition of indebtedness if other factors indicate an equity investment. See Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal", *Tax Law Review* (1971), at 369, 413.

48. See e.g. *Wood Preserving Corp. v. United States*, 347 F2d 117, 119 (4th Cir. 1965); *Commissioner v. Schmoll Fils Associated*, 110 F2d 611 (2nd Cir. 1939).

49. See Garlock, note 39, at 1019 with references.

50. See Bittker and Eustice, note 37, at 4-26; Garlock, note 39, at 1020. Plumb, note 47, at 414, states that debt that never matures is indistinguishable from cumulative preferred stock, and that an obligation which is to become payable only upon dissolution or reorganization of the corporation, or upon disposition of its properties, is not considered to have a maturity date, but rather is considered to be at the risk of the corporation. The same is said regarding situations where the life of the corporation itself is limited.

51. See Plumb, note 47, at 415-416; Bittker and Eustice, note 37, at 4-26.

52. See Plumb, note 47, at 415, referring to case law sustaining an 89-year term and 40- to 50-year terms, while a 99-year term has been found obviously unreasonable. Even a 20-year term has been viewed as an adverse factor in the debt/equity analysis.

53. See Garlock, note 39, at 1020, fn. 76.

test does not make much sense because no one knows whether any of the obligors in today's world will be around in 10 years, much less 60 years or 100 years.<sup>54</sup> In that sense, the case law could be seen as a test of credit quality: what is the assessment that the instrument will be paid? To answer this question, Humphreys has suggested the rating agencies as a good place to look.<sup>55</sup> After the warning given in Notice 94-47, issuers have limited the subordinated debt to 49 years or less. More recently, issuers have been extending maturities to 60 years, mainly because the rating agencies view that as "perpetual". However, from a US federal income tax perspective, long maturities may tip the scale on debt classification.<sup>56</sup>

Based on this, perpetual debt instruments should not expect classification as debt under US tax law.<sup>57</sup>

Although the general notion that a long maturity puts capital at the risk of the corporate borrower's business has some merit, existing case law has been criticized as being rather unsophisticated.<sup>58</sup> No distinction has been drawn among instruments that pay interest and principal periodically (self-amortizing loans), those that pay interest periodically but principal at maturity (conventional corporate debt), and those that pay interest and principal at maturity (zero-coupon bonds). Moreover, the cases have taken no account of the fact that, in the case of long-term conventional corporate debt, the bulk of the value of the instrument is found in the right to receive interest payments and not in the right to receive the principal at maturity.<sup>59</sup> Demonstrating the relative values of principal and interest for various maturities, Garlock argues that even the total absence of a fixed maturity date for principal should be given little weight in the debt/equity analysis, as long as the investor is assured of receiving fixed, periodic payments of interest.<sup>60</sup> At an interest rate of 8%, the following table shows the relative values of principal and interest as demonstrated by Garlock.<sup>61</sup>

Maturity (years)	Value of principal (%)	Value of interest (%)
1	92.46	7.54
5	67.56	32.44
10	45.64	54.36
20	20.83	79.17
30	9.51	90.49
50	1.98	98.02
100	0.04	99.96

On the basis of this, it has been concluded by leading commentators that there is no compelling reason to treat a fixed maturity date as a sine qua non of debt.<sup>62</sup> Simultaneously, it has been argued that 100-year debt (century bonds) should be treated as debt for federal tax purposes because it resembles debt more than equity; particularly where the yield difference between an issuer's 100-year debt and its (or a similar issuer's) 30-year debt is relatively small.<sup>63</sup> On the other hand, deferral of interest payments extends the real term of the lender's investment.

Accordingly, deferral of interest payment could be seen as an important factor arguing against debt.<sup>64</sup>

### 3.3. German tax law

There is a tradition for using hybrid financial instruments in Germany. However, in recent years the number of instruments has increased.<sup>65</sup> As a starting point, the financing decisions of corporations in Germany may be made under the principle of contractual freedom.<sup>66</sup> There are no statutory provisions applicable for distinguishing between debt and equity from a tax law perspective, despite the fact that different tax consequences are attached to the two financing alternatives. Nor are there any clear criteria prescribed by government pronouncements or court decisions.<sup>67</sup> 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 that the instruments are governed by German law.<sup>68</sup> Under the principle of *Massgeblichkeit*, German tax accounting generally follows the accounting treatment under com-

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54. See Humphreys, note 25, at 464.  
 55. Id.  
 56. Id. at 466.  
 57. On several occasions under the Clinton Administration, the Treasury proposed to cut interest deductibility on "super-maturity" debt with 40-, 50- or 100-year terms.  
 58. See Garlock, note 39, at 1020 et seq.  
 59. Id.  
 60. Id. A similar line of reasoning is found in Hariton, note 3, at 506, stating that the problem with the approach in case law is that it ignores the time value of money. The value of the right to receive a return of principal on long-term debt, or indeed of any payments promised in the distant future, is but a fraction of the investment. Most of the value of the instrument is attributable to the right to receive payments of interest. Creditor's rights are important, not because they protect from default the lender's right to receive principal at maturity, but because they protect from default the lender's right to receive periodic payments of interest.  
 61. Id. at 1021.  
 62. Hariton, note 3, at 508.  
 63. See Chan and Viswanath, note 14. The same conclusion is drawn by Freeman, Stevens and Hollender, note 32, at 867 on the basis of the actual pricing of a 1,000-year Luxembourg-issued bond. The authors state that it is notable that the 1,000-year bond was expected to be priced at 91 to 98 basis points over the 30-year Treasury rate, whereas some corporate 100-year bonds were yielding 84 basis points over the 30-year Treasury rate. In the view of the authors, this reinforces the conclusion that the fact that an instrument has an extremely long maturity date should not play a particular important role in determining whether the instrument is debt or equity.  
 64. Hariton, note 3, at 507, demonstrates that an investor whose entire return is deferred until maturity is more exposed to the risks of the issuer's business than one who receives semi-annual payments at a market rate. Further, it is demonstrated that the weighted average term of the payments on a 30-year zero-coupon bond is longer than the weighed average term of the payments on a 100-year bond paying interest at a market rate.  
 65. See Trapp, *Derivatives and Financial Instruments* (1999), at 321.  
 66. See Jacob, *Cahiers de Droit Fiscal International*, 2000a, at 314; Jacob, *Bulletin of International Fiscal Documentation* (2000), at 443. German tax law classification principles are described in general by Jacob, *Cahiers de Droit Fiscal International*, 2000a, at 313, in *Bulletin* (2000), at 442; Trapp, *Derivatives and Financial Instruments* (1999), at 321; Plweka and Beck, *Tax Notes International* (30 October 2006), at 375; Hey, *Hybrid Financing* (Bureau Francis Lefebvre, Loyens & Volkmaars, Oppenhoff and Rädler, 1996), at 93; Haun, *Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steuerrecht* (1996), at 53; Köhler in Piltz and Schaumburg (eds.), *International Unternehmensfinanzierung* (2006), at 137; Briesemeister, *Hybride Finanzinstrumente im Ertragssteuerrecht* (2006).  
 67. See Hey, note 66, at 97.  
 68. See Jacob, *Cahiers de Droit Fiscal International*, note 66, at 320 and *Bulletin of International Fiscal Documentation*, note 66, at 445.

mercial law, unless tax principles specifically provide otherwise.<sup>69</sup> Thus, general accounting principles must be applied.<sup>70</sup>

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.<sup>71</sup> Based on the prevailing views in literature and jurisprudence from the Federal Tax Court (*Bundesfinanzhof*, BFH), funds made available to a corporation give rise to a contribution to the corporation's equity if the following criteria are fulfilled:<sup>72</sup>

- a shareholder transfers an asset (such as money) that is susceptible to being contributed (*einlagefähig*) to the corporation's equity (this does 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 to being withdrawn by exercising unilateral creditor rights, such as by way of terminating a loan agreement; and
- the transfer results in liable capital, such that no repayment claim may be made in respect of such capital in bankruptcy proceedings involving the recipient corporation. The contributed capital may 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 perpetual debt instruments, and stated that such instruments should fulfil the so-called *Genussrechts* test in order to obtain equity classification for tax law purposes, including the following criteria:<sup>73</sup>

- the holder must have a right to participate in the current profits of the issuer of the instrument and cumulatively; and
- the holders must have a right to participate in the liquidation proceeds of the issuer. This will be the case if the holder participates in the hidden reserves existing 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, e.g. 30 years).

If at least one of the aforementioned requirements is not fulfilled, the profits derived from the instrument are treated as interest income 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 is generally tax exempt at the level of corporate holders. Based on the *Genussrechts* test mentioned above, German tax law classifies perpetual instruments (*ewige Anleihen*) as debt for tax law purposes because the test is not fulfilled.<sup>74</sup> However, the tax authorities seemingly do test maturities exceeding 30 years in order to

conclude whether profit participation (*Gewinnbeteiligung*) is present by testing the participation in the liquidation proceeds.

### 3.4. Danish tax law

#### 3.4.1. Framework: The concept of debt and claims

Hybrid financial instruments are not yet used in Denmark on the same scale as in other jurisdictions. The interest and focus are, however, increasing.

As a starting point, it should be noted that case law has not specifically dealt with perpetual debt instruments. From the perspective of a Danish issuer, equity classification is possible only if the formal requirements of equity contributions are met. Accordingly, it is more relevant to analyse whether perpetual debt instruments and super-maturity instruments are classified as debt for tax law purposes.

The relevant domestic tax provisions regarding debt instruments in Denmark are:

- Sec. 4e of the State Tax Act, regarding income taxation of interest received;
- Sec. 6e of the State Tax Act regarding interest deduction;
- Sec. 2(1)(d) and (h) of the Corporate Tax Act regarding withholding tax on interest and withholding tax on capital gains on claims, respectively; and
- Secs. 2, 3, 4, 6, 7 and 8 of the Act on Taxation of Gains and Losses on Claims and Debt regarding recognition of capital gains on claims of a Danish creditor, and capital gains or losses on debt by a Danish debtor.

If (1) a hybrid financial instrument is a debt instrument under the Danish concept of debt and (2) the other criteria developed by the courts regarding the concept of "interest" are fulfilled, then – and only then – may an interest deduction be allowed at the level of a Danish issuer.<sup>75</sup>

The existence of debt is a prerequisite for the application of the above-mentioned tax legislation. As regards the scope of the Act on Taxation of Gains and Losses on Claims and Debt, this is stated in the preparatory work to the Act in combination with the wording of Sec. 1 of the Act (using the words *pengefordringer* (claims) and *gæld* (debt)), where it is stated that all claims and debt according to such claims are covered, regardless of their kind. The Act applies to all claims and debt obligations based

69. See Jacob, *Cahiers de Droit Fiscal International*, note 66, at 321 and *Bulletin of International Fiscal Documentation*, note 66, at 446; Trapp, note 65.

70. See Trapp, note 65, at 321.

71. See Hey, note 66, at 97.

72. See Jacob, note 66 for the following criteria.

73. See Häuselmann, note 7, at 931.

74. See e.g. Briesemeister, note 66, at 147 et seq.; Brokamp and Hölzer, note 36, at 272, 274; Häuselmann, note 7, at 931.

75. Regarding Danish withholding tax on interest, it must be assumed that the same concept of "interest" applies, even though the provision contains a reference in CTA Sec. 2(1)(d) and (g) to the EU Interest and Royalty Directive (2003/49/EC) and the specific interest definition contained in the Directive.

on such claims.<sup>76</sup> The critical element in the assessment of any hybrid financial instrument is whether there is a legal claim on payment in the form of money.

The preparatory remarks to the Act on Taxation of Gains and Losses on Claims and Debt (Bill L 194 of 1997) continue the claim/debt definitions as outlined in Circular 134 of 29 July 1992, No. 4 regarding the former version of the Act.<sup>77</sup> According to the prevailing view, the notion of a claim and thus the notion of debt is based on the private law understanding of the same terms. The private law definition of a creditors claim is "a claim on a money-payment". A debt obligation arises from such claims, but there is generally no tradition to define debt for private law purposes. A loan agreement is traditionally defined as an agreement between a lender and a borrower whereby the lender places a cash amount or a credit facility at the disposal of the borrower for a certain period of time.<sup>78</sup> Based on the freedom of contract, the terms and conditions of a loan agreement can be varied as regards maturity, etc. At a minimum, a loan is, however, characterized for private law purposes by an obligation to repay the amount advanced. If no maturity has been agreed, this does not automatically lead to the conclusion that the advance should not be considered a loan for private law purposes, as such an agreement is not similar to a unilateral gift of capital.<sup>79</sup> However, debt is hardly present for private law purposes if the essential requirement of an obligation to repay the amount advanced is not fulfilled. In such instances, it is fair to assume that the advance should be regarded as a unilateral gift of capital for private law purposes.

For tax law purposes, the notion of debt is traditionally summarized as (1) a legal obligation (2) which is real and (3) which obliges the lender to repay the amount advanced and (4) an exchange of promises and payments between the parties.<sup>80</sup> This presentation of the notion of debt is, for most purposes, in line with the private law concept of debt. However, the specific substance requirement is more relevant for tax law purposes, and there are numerous cases dealing with this specific requirement in tax avoidance situations where taxpayers have taken on formal debt obligations with no real economic risk involved. Such tax avoidance schemes have generally been knocked down by the Danish courts.

### 3.4.2. Specific legislation on perpetual debt instruments

In 2004, specific legislation was introduced in order to clarify the tax treatment of perpetual debt instruments issued by financial institutions. Prior to this, the tax classification and treatment of perpetual debt instruments and super-maturity debt instruments have not been generally clarified in Danish law. The common opinion among commentators has been that perpetual debt instruments should be classified as debt for Danish tax purposes.<sup>81</sup>

In order to achieve the objective underlying the provisions in the Danish Act on Financial Institutions, the government promised to introduce specific tax law provisions to ensure debt treatment of the Tier 1 capital

instruments involved. Accordingly, specific provisions were introduced as Sec. 6B of the Tax Assessment Act and Sec. 1(5) and (6) of the Act on Taxation of Gains and Losses on Claims and Debt.<sup>82</sup>

The background for the introduction is explained in the preparatory remarks to Bill L 60 of 2004, which states that the purpose of the bill is to provide specific tax legislation ensuring debt treatment for instruments that do not qualify for debt treatment under the general rules. It is stated that perpetuals do not fulfil the case law requirements to qualify as debt. Seemingly, the primary argument from the Minister of Taxation is that the debtor under a perpetual debt instrument is not legally obliged to repay the debt if no maturity date has been agreed, and moreover exclusively decides whether to repay the debt or not. In the opinion of the Minister of Taxation, this is contrary to ordinary debt where repayment takes place upon the demand of the creditor.

Sec. 6B(1) of the Tax Assessment Act stipulates that debt which does not mature at a specified date should obtain the same tax treatment as other debt instruments. It is not totally clear whether this refers to a specific point in time or whether a future event is sufficient. The objective of the requirement seems to be to exclude instruments where the debtor determines the date of repayment, if any.<sup>83</sup> From the investors' perspective, Sec. 1(5) of the Danish Act on Taxation of Gains and Losses on Claims and Debt stipulates that claims which do not mature at a specified date should obtain the same tax treatment as other claims, and from the issuers' perspective the same applies to debt under Sec. 1(6). In order to qualify for this tax treatment, both the investor and the issuer must fulfil the following requirements:

- *The debt obligation must be based on the issuance of the debt instrument. If the debt is dematerialized, the debt must be registered in a security centre.* This criterion is elaborated in the preparatory remarks to the bill, which states that the debt instrument must be issued by the final debtor as proof that the debtor has received the loan. Only the debtor may decide when repayment should take place (including no repayment at all). Loans repaid at the demand of the creditor fall outside the scope of the provision.

76. See Sec. 1(1)(1) and (2).

77. Examples mentioned here are bonds, mortgage deeds and notes.

78. See e.g. Bryde Andersen, *Enkelte transaktioner – Aftaleretten III* (2004), at 126; Bryde Andersen and Lookofsky, *Lærebog i obligationsret I* (2000), at 107.

79. See the memo prepared by the Legal Advisor to the Danish Government, printed as Enclosure 92 to Act 457 of 9 June 2004 (Bill L 60).

80. For the most extensive analysis of the notion of debt in Danish tax law, see Ramskov, *Intern selskabsomstrukturering* (2001), at 333.

81. See Banner-Voigt and Wittendorff, *Derivatives and Financial Instruments* (2000), at 3; Severin Hansen and Baxter, *Cahiers de Droit Fiscal International*, Vol. LXXXVa (2000), at 266.

82. See Act 457 of 9 June 2004 (Bill L 60).

83. This interpretation is supported by the comment of the Minister of Taxation in Enclosure 76 to Bill L 60, where it is stated the Minister of Taxation recognizes the existence of a debt obligation in cases where a mortgage deed can be terminated by the creditor by change of ownership, irrespective whether a maturity date has been agreed.

- *The lender under the debt instrument must be a state, a credit institution under Art. 1(1)(a) of Directive 2000/12/EC, a firm of stockbrokers, an investment service company or an insurance company or similar resident in another EU/EEC Member State.* Other companies, institutions and individuals do not fall under the scope of the provision. According to the wording, there are strict limitations regarding the debtors included, but no limitation regarding the creditors included. The limited scope is based on the risk that a payment which is taxable for the recipient, can be disguised as a loan without maturity, whereby taxation may be avoided. By the narrow personal scope on the creditor side, the intention is to reduce the risk that related parties transfer money by issuing perpetual loans replacing taxable gifts and contributions. Majority shareholders and their companies and families are specifically mentioned in the preparatory remarks.
- *The creditor must, under the loan agreement, receive an annual interest, and the interest terms must be determined no later than at the time of the issuance of the debt instruments.* The terms may be changed only according to factors outside the influence of the investor and the lender. The calculation of the interest may take place on a monthly, quarterly, semi-annual or annual basis. The terms regarding the interest calculation must be in place at the time of the issuance of the instrument. The interest may be fixed or variable, but not zero, due to the specific requirement that the creditor must have a yield.

### 3.4.3. Classification and treatment of perpetual debt instruments and super-maturity debt instruments outside the scope of the specific legislation

As stated above, there is no doubt that the scope of the specific provisions of Danish tax law on perpetuals is rather narrow as regards the debtors included. Therefore, ordinary corporate issuers are not able to apply the specific provisions. The question, however, remains whether such corporate debtors may issue perpetual instruments and obtain debt treatment outside the scope of the specific legislation.

No case law clarifies the tax treatment of perpetual instruments outside the scope of Sec. 6B of the Tax Assessment Act. Moreover, this question has not generally been clarified by the introduction of the specific legislation. As noted above, the Danish Minister of Taxation is obviously of the opinion that perpetual debt instruments do not resemble pure debt and accordingly cannot obtain debt treatment.<sup>84</sup> This conclusion is based on the understanding of perpetual debt that no repayment has been agreed and that the lender therefore decides whether and at what time (if any) the debt should be repaid. According to the understanding of the Minister of Taxation, this is in contrast to ordinary debt payable at the discretion of the creditor.

However, strong arguments can be presented in contradiction to the opinion of the Minister of Taxation, and

accordingly in favour of debt treatment. First, the interpretation of the Minister of Taxation was contradicted in the hearing process.<sup>85</sup> The Minister of Taxation, however, insisted on maintaining his interpretation.<sup>86</sup>

As a consequence of the doubt raised during the treatment of the Bill in the parliament, the Legal Advisor to the Danish government (*Kammeradvokaten*) was asked to clarify the interpretation with regard to interest deductibility.<sup>87</sup>

Initially, the memo prepared by the Legal Advisor to the Danish government establishes that the hybrid Tier 1 capital constitutes debt for private law purposes. It is stated that hybrid Tier 1 capital (including perpetual instruments) deviates from the traditional concept of a loan for private law purposes, in the sense that no maturity is agreed and the principal is not to be repaid on the creditor's demand. Irrespective of these features, it is concluded that this does not lead to the conclusion that hybrid Tier 1 capital (perpetuals) does not constitute a loan with a legal obligation for the debtor. This conclusion primarily results from the freedom of contract as regards the specific terms and conditions on the loan and repayment of the instrument. Based on this, it is concluded that hybrid Tier 1 capital does not represent a unilateral gift of capital. Accordingly, the Legal Advisor to the Danish government concludes that the obligation to repay the advance should be considered real due to the fact that the debtor can be released from the obligation only by way of full repayment. In other words, the debt obligation does not disappear, even though theoretically the obligation may exist indefinitely if the debtor never initiates repayment of the debt. The Legal Advisor to the Danish government moreover assumed that the notion of interest under Danish tax law is governed by the private law notion of interest payments (with the function of a legal fact) and that no specific, strong reasons to detach the tax law notion from the private law notion of interest payments exist.

In conclusion, hybrid Tier 1 capital – in the opinion of the Legal Advisor to the Danish government and with the uncertainties following the lack of theory and prac-

84. According to the description of current law in the preparatory work, the Minister of Taxation has stated that if a debtor under an instrument is not obliged to repay the debt, this does not constitute debt for tax law purposes and the interest payments are accordingly not considered interest for tax law purposes. See the preparatory remarks to Act 457 of 9 June 2004 (Bill L 60).

85. See Enclosure 71 to Act 457 of 9 June (Bill L 60), where the Association of State Authorized Public Accountants argued that an amendment of the legislation was unnecessary in order to ensure deductibility regarding perpetual instruments issued by financial institutions. Reference was made to a decision referred to in LSRM 1955, 76, where interest deduction was allowed under a mortgage bond where a taxpayer had donated the bond to a Catholic organization as a member of the Roman Catholic Church. The mortgage bond was irredeemable except in cases of change in ownership. Moreover, the Catholic institution was obliged to reduce or abstain from demanding interest payments. In Enclosure 92 to Bill L 60, the Legal Advisor to the Danish government states that the mentioned ruling is irrelevant to perpetual instruments. This author tends to agree with such conclusion.

86. See Enclosure 76 to Bill L 60, where it is argued that the redemption clause in the bond in the decision referred to above resulted in the debtor not being able to decide whether repayment of the debt should take place.

87. See Enclosure 92 to Bill L 60.

tice regarding the issue – which it is within the scope of Sec. 6(1)(a) of the Danish State Tax Act is to be considered as debt for tax law purposes, or at least to be viewed as a loan relationship comparable to debt, regardless of the indefinite maturity. Accordingly, the yield was considered deductible for Danish tax purposes. Considering the legal uncertainty, the Legal Advisor to the Danish government, however, applauded the initiative to clarify the tax treatment of hybrid Tier 1 capital instruments by way of enacting specific legislation regarding the subject.

Based on the above analysis, it would be fair to assume that the discussion was finally brought to an end regarding instruments outside the scope of the specific legislation on perpetuals. This is, however, by far the case, and uncertainty as regards the tax classification of perpetual instruments outside the scope of Sec. 6B of the Danish Assessment Act continues to exist.

Accordingly, analysing the classification and tax treatment of perpetual debt instruments and super-maturity debt instruments is still relevant when such instruments are used in the corporate sector. The question is whether perpetual instruments should be considered debt for Danish tax purposes and whether the yield on perpetual instruments is deductible for Danish tax purposes outside the scope of Sec. 6B of the Tax Assessment Act. More precisely, the question is whether an *e contrario* interpretation of the presented specific legislation excludes debt treatment outside the scope of the mentioned provisions.

In light of the interpretation of the Minister of Taxation presented above, it is not surprising to see the provisions in Sec. 6B of the Danish Assessment Act and Sec. 1(5) of the Act on Taxation of Gains and Losses on Claims and Debt being interpreted by the tax authorities so as to deny interest deductions on perpetual instruments outside the scope of the provisions.<sup>88</sup> Whether this is a correct interpretation depends on whether the interpretation laid down in the remarks to Bill L 60 is correct.

Most recently, a new type of mortgage obligation has been introduced on the Danish market for private housing, so-called SDO loans (*Særligt Dækkede Obligationer*). These loans may mature 100 years or more from the time of issuance. In some of the loans, there are no payments on the principal, but only interest payments.<sup>89</sup> Under the amended Sec. 152d of the Danish Act on Financial Activity, mortgage obligations may be issued without a specified maturity date. However, these new loans should not exceed 75% of the value of the real estate. The preparatory remarks to the Act stated that interest deductibility for tax law purposes requires that a maturity date have been agreed. The background for this specific statement is found in the Hearing Answer from the Minister of Taxation regarding Bill L 199, where it is stated that the tax law consequences should be considered, and that it is a requirement to obtain an interest deduction for debt without agreed maturity that the conditions under Sec. 6B in the Danish Tax Assessment Act be fulfilled. According to the Minister of Taxation, debtors under the SDO Act do not fall under the scope of

Sec. 6B of the Danish Tax Assessment Act. Accordingly, interest deductibility regarding SDO loans requires an agreed maturity date according to the Minister of Taxation.

In this author's opinion, it is doubtful whether the firm statement in the preparatory remarks to Bill L 60 and Bill L 199 as presented above is correct.<sup>90</sup> When also taking into consideration that no case law directly involves perpetual instruments, the question is – at the very least – surrounded by more uncertainty than assumed by the Minister of Taxation.<sup>91</sup>

Under the wording of the specific provisions aimed at perpetual instruments, one is left with the impression that the provisions are generally applicable, i.e. that debt, claim and interest treatment are not allowed generally for perpetual debt instruments outside the scope of the provisions. Taking the *ratio legis* into consideration, the provisions in Sec. 6B of the Tax Assessment Act and Sec. 1(5) and (6) of the Act on Taxation of Gains and Losses on Claims and Debt should be read as provisions intended to provide clarity for financial institutions issuing hybrid Tier 1 capital. Accordingly, the preparatory work regarding the provisions does not support the apparent narrowing of the scope of Sec. 6(1)(e) of the State Tax Act and the Act on Taxation of Gains and Losses on Claims and Debt in general without clear statements on such a purpose being stated explicitly.

One commentator, Falk, has found some support in case law regarding the recognition of loan agreements without agreed maturity as debt for tax law purposes.<sup>92</sup> The relevant case is Tfs 1997, 102 Ø, which concerns a Danish public limited liability company that had granted a so-called *villkorligt aktieägartilskott* to its Swedish subsidiary. The companies were jointly taxed under Danish tax law. Under Swedish law, a *villkorligt aktieägartilskott* is considered a special form of interest-free loan used to re-establish the equity of companies in order to fulfil the Swedish solvency requirements, as an alternative to a traditional increase of share capital. The question was whether the Danish tax authorities should accept that the loan was interest free or whether the arm's length principle would apply, whereby a deemed interest would be taxed in the hands of the Danish parent company (as creditor). The Eastern High Court found that the advance of *villkorligt aktieägartilskott* should be consid-

88. See Falk, *Re&R* 2005/9, at 35 referring to unofficial practice of the tax authorities.

89. See Act 577 of 6 June 2007 (Bill L 199).

90. This view is supported by the memo prepared by the Legal Advisor to the Danish Government, and previously Banner-Voigt and Wittendorff, note 81, at 3. The result seems moreover assumed by Severin Hansen and Baxter, note 81, at 266.

91. The obligation to repay a loan has been considered a *conditio sine qua non* regarding debt classification for some years from the perspective of the Danish legislature. Accordingly, Sec. 7 D of the National Assessment Act allows debt treatment for loans from a specific public venture fund (*Vækst-fonden*) irrespective of the term that such loans should only be repaid if the project is utilized commercially. The preparatory remarks to the Act, cf. Act 336 of 1995 (L 124), state that such loans may not be considered loans in the absence of the specific provision granting such a classification.

92. To this effect, see Falk, note 88, at 35.

ered a normal business transaction which independent parties would also have entered into. Accordingly, no interest income should be deemed in the hands of the Danish parent company. Details on the Swedish regime on *villkorligt aktieägartilskott* were submitted by Swedish authorities before the Court.<sup>93</sup> Here it was asserted that the instrument was considered equity also for bankruptcy purposes, and that the instrument was used as an alternative to traditional share capital increases. For accounting purposes the contributions were treated as other equity contributions. It was also asserted that the contributions must be repaid only when decided by the shareholders of the company at a shareholders' meeting. The contribution may be repaid when the income of the company allows a repayment without a reduction of the share capital to fall under the minimum capital requirements for Swedish company law purposes. *Villkorligt aktieägartilskott* are considered debt only when repayment has been decided. Moreover, the repayment should follow the Swedish company law requirements regarding the payment of dividends. Finally, it was asserted that interest payments were not made on the contributions. The Danish Eastern High Court found that *villkorligt aktieägartilskott* may be considered a special form of interest-free subordinated loan used to re-establish the equity of companies in order to fulfil the solvency requirements under Swedish law. Based on this, the Court found that the zero-interest term should not be regarded as an unusual disposition that would trigger a deemed interest adjustment in Denmark.

In the opinion of this author, this case provides only little support with regard to perpetual instruments, as the case concerns another issue than the one analysed here, i.e. whether allowing the Swedish subsidiary zero interest is in accordance with the arm's length principle. In the author's opinion, the reference made to Swedish law merely indicates that the contribution under Swedish law is considered a special type of loan. It is often seen that the specific features of foreign law serve as legal facts with regard to the Danish interpretation in cross-border transactions. There is no discussion in the case of whether the contribution should be considered debt for Danish tax law purposes.<sup>94</sup>

A more recent case involves the same type of contribution. The treatment of debt without a fixed maturity seems more precisely to have been dealt with in TFS 2000, 105 H Premier IS A/S. This case also deals with *villkorligt aktieägartilskott*, however, with the difference compared to the case presented above that the contribution was granted by converting the claims arising from delivery of goods to a Swedish subsidiary from a Danish parent company. The question brought before the Court was whether a loss suffered by the Danish parent company by way of a contribution was deductible for tax purposes. The High Court and the Supreme Court stated that a *villkorligt aktieägartilskott* should be regarded as a loan for tax purposes.

Even though this case is more precise with regard to the classification of the contribution under Swedish law, it

can hardly be stated that the Supreme Court hereby directly has classified perpetual debt instruments for tax law purposes. The term of the contribution regarding non-repayment/no maturity did not play any role in this case. Moreover, other features are typically present in perpetual instruments.

Even in the light of the above-mentioned very limited support found in case law, there are a number of arguments in support of the conclusion that the interpretation as followed by the Minister of Taxation is incorrect.<sup>95</sup> First, it can be pointed out that should the Minister's interpretation prevail, ordinary overdraft facilities and other loans without a fixed maturity would not be regarded as debt for tax purposes. Such a conclusion would obviously have tremendous practical implications. Another result would be that claims based on perpetual instruments outside the scope of the specific provisions would then be considered a tax-exempt asset under Sec. 5(a) of the Danish State Tax Act, which would result in tax exemption from potential capital gains. A third result of such an interpretation would be that all other characteristics of the tax law definition of debt and interest would not have to be fulfilled by instruments under the scope of Sec. 6B and Sec. 1(5).

Accordingly, it seems fair to conclude that the introduction of the specific provisions does not influence interest deductibility and debt treatment outside the scope of the specific provisions. However, it should be acknowledged that this interpretation is subject to uncertainty, because no case law involving perpetual debt exists and because the opinion of the Minister of Taxation is clear.

Falk concluded that the amendments introduced by Bill L 60 seem to be based on a misunderstanding of current law.<sup>96</sup> According to Falk, this has the unfortunate consequence that Danish corporations are impeded in achieving the rating (and accordingly financing) benefits linked to perpetual instruments. Moreover, according to Falk, what was meant to be an easing of the tax treatment of financial institutions may in fact have turned out to be an unforeseen tightening of the rules for other Danish companies. Based on this, Falk urges the Minister of Taxation to restore the situation as before Bill L 60.

Furthermore, super-maturity loans with a maturity of 1,000 years have been accepted as debt for tax purposes by the tax authorities. It would seem artificial to apply a distinction between perpetual debt and super-maturity debt, as the economic contents are almost identical and where the economic value of the repayment of the loan in 1,000 years is absolutely insignificant. The Legal Advisor to the Danish government supports this conclusion

93. Also on this subject, see Prytz and Tamm, *Tilskott utan aktieteckning* (1995).

94. The commentary may, however, also be understood so as to support the existence of debt for Danish tax purposes in the actual context. See the commentary by the Minister of Taxation in TFS 1997, 452; Wittendorff in SR-Skat 1997, at 300; Bostrup, SpO 1997, at 146.

95. To this effect, see Falk, note 88, at 35.

96. Id.

in the memo mentioned above, which states that in the process of classifying instruments, it makes no sense to apply a distinction between perpetual debt and debt maturing in several hundred years for tax law purposes. Indeed, the memo states that the decisive issue should be a total assessment of the nature of the loan in question.<sup>97</sup>

If, on the other hand, it is assumed that the governmental interpretation is correct, this, moreover, gives rise to the question of whether a specific maturity date must be agreed in order to fulfil the requirements established by the Danish tax authorities to qualify for debt treatment. Seemingly, to the Minister of Taxation, the decisive issue is whether the debtor may decide whether repayment should take place. In the preparatory remarks, such loans are the opposite of debt that is to be repaid upon the creditor's demand. Under Danish law, the debtor is obliged to repay the debt when the creditor demands it, if no specific agreement has been made.<sup>98</sup> In order to violate the requirement of the Minister of Taxation that the debtor may not decide unilaterally whether the debt should be repaid, this requires that a specific agreement have been made that the repayment should not be made at a specific point in time. In all other cases where no repayment date has been agreed, the starting point would be that the debt instead falls outside the scope of the provisions in LL Sec. 6 B and KGL Sec. 1(6) and at the same time falls outside the description of the current law as assumed in the preparatory remarks to these provisions. Consequently, debt treatment would still exist in such situations.

#### 4. Classification under EU Corporate Tax Directives

On the EU law front, two directives come into play concerning the tax treatment of perpetual debt and super-maturity debt instruments and the remuneration thereon, namely the Parent-Subsidiary Directive<sup>99</sup> and the Interest and Royalty Directive.<sup>100</sup> Basically, the Parent-Subsidiary Directive applies to equity financing, while the Interest and Royalty Directive applies to debt financing.

The Interest and Royalty Directive is more informative than the Parent-Subsidiary Directive in terms of defining the payments included under the scope of the respective Directive. The notion of interest is defined directly in Art. 2(1)(a) of the Directive as:

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 by the European Commission as follows:

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.<sup>101</sup>

It is interesting to observe that the notion of interest is intended to be similar to that under the OECD Model Tax Convention (OECD Model). Accordingly, the notion of interest includes capital gains.<sup>102</sup> The notion of debt claims also seems broad. The wording refers to debt claims of any kind. Based on this, any debt claim that is a debt claim for private law purposes falls under the scope of the Interest and Royalty Directive. At first glance, the notion of interest under the Interest and Royalty Directive is particularly broad and also includes yields from certain hybrid financial instruments.<sup>103</sup> Seemingly, in the view of the EU Commission, this should also include perpetual debt and super-maturity debt.

However, Art. 2 should be read in conjunction with Art. 4 of the Directive in order to assess the actual scope of the interest definition.<sup>104</sup> In Art. 4 of the Interest and Royalty Directive, the source state is granted the right not to ensure the benefits of the Directive in cases where some common types of hybrid financial instruments are used. The relevant portion of Art. 4 provides as follows:

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:

[...]

(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.

Member States may decide whether the benefits of the Interest and Royalty Directive are granted with regard to financial instruments under the scope of Art. 4 of the Directive.<sup>105</sup> Super-maturity debt and perpetual debt fall under the scope of this provision. Accordingly, such instruments and the yield thereon may fall outside the scope of the Interest and Royalty Directive. The enumeration of excluded financial instruments should be considered exhaustive, in contrast to previous drafts of the Directive.<sup>106</sup> An *e contrario* interpretation should lead to the conclusion that in the absence of this specific provision in Art. 4(1)(d) such instruments would fall under the scope of the interest definition.

97. See the memo prepared by the Legal Advisor to the Danish government, printed as Enclosure 92 to Act 457 of 9 June 2004 (Bill L 60).

98. See Sec. 5 Danish Act on Promissory Notes.

99. 90/435/EEC.

100. 2003/48/EC.

101. COM (1998)67 final, at 6.

102. Government bonds are not covered by the Directive, as Member States are not considered companies that fall under the scope of the Directive. See Gusmeroli, *European Taxation* (2005), at 39, 44.

103. See Distaso and Russo, *European Taxation* (2004), at 149.

104. Id.

105. See Distaso and Russo, note 103, at 143, 149. For intensive coverage on the actual exercise of this right by the Member States, see IBFD, *Survey on the Implementation of the EC Interest and Royalty Directive* (2006).

106. See Weber, *EC Tax Review* (2000), at 25.

The overall policy background underlying Art. 4 is explained by the European Commission, as follows:

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 recharacterized 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.<sup>107</sup>

It remains unclear precisely why the Member States have been given the option to exclude certain hybrid financial instruments from the scope of the Directive rather than generally excluding the instruments from the scope of the Directive. In general, the limitations contained in Art. 4 have been questioned by commentators. For example according to Distaso and Russo:

Looking at the cases provided for by Art. 4(1) of the Directive, it seems that the Member States, apart from cases under letter (a), will be allowed to deny the application of the Directive (i.e. the exemption from withholding tax on interest) irrespective of the fact that the payments under debt claims as described under letters (b), (c), (d) are treated as profit distributions in that Member State. Therefore, such payments may still keep their characterization as interest under the laws of the source state but may nonetheless be subject to withholding tax on interest in the same state. Frankly, the rationale behind the denial of the benefits of the Directive is difficult to understand without the reference to a corresponding profit recharacterization or a limitation of the deduction of the interest expense in the source state. A justification may be found by assuming that through the cases mentioned under letters (b), (c), (d), the Directive has granted the source state the possibility of levying withholding tax on interest if the payments under the financial instruments described are still treated as interest in the source state but are characterized as profit distributions in the Member State of the recipient. In other words, the Directive's intention would be to "hit" those instruments that create a tax deduction in the source state and which give rise to an exemption from taxation of the correspondent income received in the residence state (or state of establishment) of the recipient, as such income would be characterized as a profit distribution ...<sup>108</sup>

If this analysis is correct, Art. 4 of the Directive in fact constitutes a tax arbitrage shield without specifically pointing towards this issue in the wording. Moreover, the clause is now generally applicable even though the policy rationale leads to a rather limited scope.

If the Member States in question do not exercise the right to exclude perpetual debt instruments and super-maturity debt instruments from the benefits of the Directive, this means that such instruments may in fact benefit from the Directive. In such situations it becomes relevant whether other features such as interest-deferral mechanisms are in line with the interest definition in Art. 2. Referring to the interpretation below regarding Art. 11 of the OECD Model, such an interpretation would, however, be doubtful.

Payments that are treated as a distribution of profits or as a repayment of capital under the law of the source state

are excluded from the Interest and Royalty Directive under Art. 4(1)(a). This exclusion has a rather broad scope and should include yields from some forms of hybrid financial instruments, as well as interest subject to thin capitalization legislation in the source state, which results in a reclassification of interest to dividends.<sup>109</sup> The effect of Art. 4(1)(a) on national thin capitalization provisions that do not result in a reclassification is yet uncertain.<sup>110</sup> In line with the analysis presented above, it is commonly agreed by commentators that such payments treated as distributions of profit in the source state should fall under the scope of the Parent-Subsidiary Directive instead.<sup>111</sup> This was also explicitly stated by the European Commission regarding the previous draft to the Directive.<sup>112</sup>

A similar result is not presupposed as regards the interest payments mentioned under Art. 4(1)(b)-(d). However, if such payments (including interest payments on perpetu-als) are in fact reclassified as "distributed profits", the same interpretation ought to apply to such payments, as well. Accordingly, the Parent-Subsidiary Directive may be said to take precedence over the Interest and Royalty Directive.<sup>113</sup> It has been argued in tax literature that the Parent-Subsidiary Directive includes income from hybrid debt, which, by nature, is actually equity and therefore taxed as a dividend in the Member States.<sup>114</sup> Based on this, it has also been argued that the Parent-Subsidiary Directive is applicable to income from perpetual debt if Member States choose to tax interest on perpetual debt as a dividend.<sup>115</sup> Finally, it has been argued that the Parent-Subsidiary Directive is applicable to perpetual loans from a corporation to its shareholder if the loan itself under domestic law is considered a constructive dividend and constitutes a distribution of profits from a subsidiary to the parent company, made by virtue of the association between the companies.<sup>116</sup>

Payments on perpetual debt instruments and super-maturity debt instruments falling outside the scope of the Interest and Royalty Directive do not automatically fall under the scope of the Parent-Subsidiary Directive. Accordingly, there is no guarantee that payments on perpetual and super-maturity debts instrument that have been denied the rights under the Interest and Royalty

107. COM (1998)67, at 8.

108. See *European Taxation* (2004), at 150. Also to this effect, see Eberhartinger and Six, *National Tax Policy, The Directives and Hybrid Finance* (2006), at 25.

109. Also regarding the latter, see Distaso and Russo, note 103, at 150.

110. See Gusmeroli, *European Taxation* (2005), at 39, 44.

111. See Eberhartinger and Six, note 108, at 23. and Distaso and Russo, note 103, at 150.

112. COM (1998)67 final.

113. Eberhartinger and Six, note 108, also raise the question of what will happen if payments that qualify as profit distributions under the tax law of the source state fall under the scope of the Parent-Subsidiary Directive, and if the source state does not execute the option in Art. 4(1)(a) of the Interest and Royalty Directive and if these payments fall under the scope of both Directives.

114. Cf. Helminen, *The Dividend Concept in International Tax Law* (1999), at 282.

115. *Id.*

116. *Id.*

Directive are granted the rights under the Parent-Subsidiary Directive instead.

## 5. Classification under Income Tax Treaties

### 5.1. In general

In general, the remuneration on hybrid financial instruments may be classified as interest payments under Art. 10, as interest payments under Art. 11 or as other income under Art. 21 in income tax treaties that are based on the OECD Model. For the sake of simplicity, only the dividend provision and the interest provision are analysed here with regard to perpetual debt instruments and super-maturity instruments. The demarcation is of great importance, as the taxing right under the treaties differs depending on the type of income.

The concept of “dividends” is defined in Art. 10(3) of the OECD Model as follows:

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.<sup>117</sup>

It is impossible to define the term “fully and exhaustively” in view of the significant differences between the laws of OECD member countries.<sup>118</sup>

The term “interest” is defined in Art. 11(3) of the OECD Model 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.<sup>119</sup> A reference to domestic law is not made, and the definition is considered autonomous.<sup>120</sup>

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 Arts. 10 and 11, respectively, the term “interest” as used in Art. 11 does not include items of income dealt with under Art. 10.<sup>121</sup> The same should apply with regard to hybrid financial instruments, even though this is not stated directly.<sup>122</sup> Accordingly, one should analyse whether remuneration on perpetual instruments in principle falls under the scope of Art. 10 of the OECD Model, as this would lead to such remuneration not being covered by Art. 11 of the OECD Model.

### 5.2. The corporate rights test

The most essential part of the OECD Commentary with regard to hybrid financial instruments is Para. 25 of the OECD Commentary to Art. 10. This states that Art. 10 deals not only with dividends as such, but also with interest on loans insofar the lender effectively shares the

risks run by the company (i.e. 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 Art. 7 of the OECD Model, regarding business income, which also requires a delimitation of the notion of business risk.<sup>123</sup> Thus, business income under Art. 7 should also be delimited against income from debt claims under Art. 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 in terms of distinguishing dividends from interest are the same as those applying to the distinction between interest and the partners’ shares in profits.<sup>124</sup> A dividend recipient must accept an entrepreneurial risk corresponding to that of a regular shareholder. It is not sufficient that the risk be 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.<sup>125</sup>

The exact scope of the term “corporate rights” as used in Art. 10 of the OECD Model is not clear. Nevertheless, certain criteria for the classification of corporate rights may be derived. 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.<sup>126</sup> The term “corporate rights” should not be interpreted in its narrow sense, requiring that their holder be entitled to the full rights of a regular shareholder, including voting rights and control rights over the company.<sup>127</sup> According to leading commentators, the notion of corporate rights includes a second criterion besides the above-mentioned one. The second criterion is that the holder of a corporate right must at least

117. See in general regarding the interpretation of this Article, e.g. Baker, *Double Taxation Conventions* (2003), at 10-1 et seq.; Vogel, *On Double Taxation Conventions* (1997), at 646 et seq.; Helminen, note 114; Lang, *Hybride Finanzierungen im Internationalen Steuerrecht* (1991), at 85 et seq.; Schuch, in Bertl et al. (eds.), *Eigenkapital* (2005), at 217 et seq.; Giuliani, *Bulletin of International Fiscal Documentation* (2002), at 11 et seq.; Fehér, in *Conflicts of Qualification in Tax Treaty Law*, Burgstaller and Haslinger (eds.) (2007), at 227, 234.

118. See Para. 23, OECD Commentary to Art. 10(3).

119. See Para. 21, OECD Commentary to Art. 11; Baker, note 117, at 11-4, m. 11B-08; Six, *Hybrid Finance in the Double Tax Treaties* (2006), at 6; Vogel, note 117, at 732, m. 58.

120. Para. 21 OECD Commentary to Art. 11; Six, note 119, at 6; Schuch, note 117, at 229.

121. See Para. 21 OECD Commentary to Art. 11; Helminen, note 114, at 271 and the same in *European Taxation* (2004), at 56, 58; Six, note 119, at 7.

122. 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 regard to the specific discussion of thin capitalization situations.

123. See Schuch, note 117, at 225.

124. See Vogel, note 117, at 651, m. 189.

125. See Vogel, note 117, at 651, m. 189; supportive, Helminen, note 114, at 273.

126. See Giuliani, note 117, at 14, Lang, note 117, at 125, Six, note 119, at 5.

127. See Vogel, note 117.

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.<sup>128</sup> Moreover, this means that the repayment to the holder must be subordinated to the claims of other creditors. Based on this, Vogel summarizes the requirements for a corporate right to exist as (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).<sup>129</sup>

The wording of Art. 10 of the OECD Model, however, does not explicitly list these criteria, nor does it go into detail on how these two criteria must be formulated in order for a specific hybrid instrument to be classified as a dividend-generating instrument (equity). The broad scope of possible characteristics of hybrid instruments consequently makes it difficult to decide whether the two above-mentioned criteria are fulfilled.<sup>130</sup> 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 classification of the financial instrument as a corporate right must therefore be evaluated in each individual case in light of all the facts and circumstances of the financial instrument in question.<sup>131</sup> Only upon fulfilment of this test will the investment qualify as equity and thus as being dividend-generating from a tax treaty perspective.<sup>132</sup>

A hybrid financial instrument with a profit-participating right, as well as a right to participate in the liquidation proceeds of the issuing company therefore does not yield income from debt claims under Art. 11(3) of the OECD Model, as the terms “income from corporate rights” and “income from debt claims” with regard to tax treaties are mutually exclusive.<sup>133</sup> Therefore, from a treaty perspective, such instruments generate income from corporate rights (dividends) under Art. 10(3), rather than interest income under Art. 11(3). However, if on the other hand, the instrument meets only one of the two criteria established above, the yield should not be regarded as a dividend, but rather as interest income under Art. 11(3).<sup>134</sup>

Applied to perpetual instruments and super-maturity instruments, it is clear that the lack of a fixed maturity date alone does not make a debt claim a dividend-generating right. A pure perpetual debt does not entitle the investor to participate in profits.<sup>135</sup> Accordingly, under the corporate-rights test, such instruments should be classified as interest-generating instruments (i.e. debt).

### 5.3. The debt claim test

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

The term “debt claims of every kind” as used in Art. 11 of the OECD Model is not defined.<sup>136</sup> 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.<sup>137</sup> The enumerations should be seen as exemplary and do not influence the universal character of the definition itself.<sup>138</sup> The term “debt claims” should moreover be understood in its broadest sense.<sup>139</sup> Generally, “interest” under Art. 11 includes all that the issuer pays over and above the amount paid by the subscriber, i.e. interest accruing plus any premium paid at the redemption or upon issuance.<sup>140</sup> More generally, it may be said that interest encompasses remunerations for making capital available to the debtor.<sup>141</sup>

There is no interest in the absence of an underlying claim. Accordingly, the existence of a claim is a *conditio sine qua non* with regard to interest classification for tax treaty purposes.<sup>142</sup> Seemingly, the notion of a debt claim should be understood in accordance with private law.<sup>143</sup> This requires that there be 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.<sup>144</sup>

In a comprehensive analysis of the classification of reverse convertibles, Rotondaro has analysed the notion

128. See Helminen, note 114, at 271, Lang, note 117, at 124; Six, note 119, at 5, 129. Id.

130. See Six, note 119, at 5.

131. See e.g. Helminen, note 114, at 272. See also Baker, note 117, at 10-12, m. 10B-22, stating that this is a fact-and-circumstances test, and providing the following examples: (1) the loan very heavily outweighs any other contribution to the enterprise's capital (or was taken out to replace a substantial portion of capital which has been lost) and is substantially unmatched by redeemable assets; (2) the creditor will share in any profits of the company; (3) repayment of the loan is subordinated to claims of other creditors or to the payment of dividends; (4) the level of payment of interest would depend on the profits of the company; and (5) the loan contract contains no fixed provisions for repayment by a definite date.

132. See also Helminen, note 114, at 274.

133. See Lang, note 117, at 120 et seq., Helminen, note 114, at 271, Six, note 119, at 7.

134. See Lang, note 117, at 133, Six, note 119, at 7.

135. See Helminen, note 114, at 283, 284 (“Therefore, in practice, under all of the treaties covered in this study, income from perpetual debt is treated as a dividend only if other equity characteristics are involved”).

136. See e.g. Six, note 119, at 6.

137. See Para. 18, OECD Commentary to Art. 11.

138. See Six, note 119, at 6.

139. See Vogel, note 117, at 732, m. 59.

140. See Para. 20, OECD Commentary to Art. 11.

141. See e.g. Vogel, note 117, at 731, m. 56, Lang, note 117, at 96; Schuch, note 117, at 229; Six, note 119, at 7. Vogel's definition is further developed, at 733, m. 60 (“Interest is no more than the remuneration received for making capital available subject to repayment, and does not include profits from providing funds in cases where the provider accepts the hazards of the borrower's business (Para. 18 MC Comm., supra m. 50). This distinguishes interest from business profits within the meaning of Art. 7 – to the extent that such profits, too, are made by providing capital – and from dividends within the meaning of Art. 10. The fact alone that the provider assumes no liability beyond the provision of the sum lent does not necessarily characterize as “interest” of the payments he receives in respect thereof, because the provider may be involved in some other way in the hazards of the borrower's business”). In its decision, the Supreme Court of Canada (*Queen v. Melford Developments Inc.*, 1982 CarswellNat 209, [1982] C.T.C. 330, [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 under the Canada-Germany treaty was the remuneration received by the lender in exchange for allowing the borrower to make use of the principal. See Rotondaro, *Derivatives and Financial Instruments* (2000), at 264, regarding the case.

142. See Vogel, note 117; Schuch, note 117, at 228.

143. See Schuch, note 117, at 229.

144. See Art. 11(6), OECD Model referring to the “payer” and to the “beneficial owner”. For commentary, see Schuch, note 117, at 229. This interpretation clearly affects loans to partnerships.

of “interest” as applied in Art. 11(3) of the OECD Model.<sup>145</sup> 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 Art. 11 of the OECD Model.<sup>146</sup> He states that, irrespective of the fact that uncertainty is present in an instrument regarding the yield, this does not exclude interest classification under tax treaties; the opposite conclusion is to be made regarding uncertainty as concerns the redemption of the principal.<sup>147</sup> Following this view, there can be interest under Art. 11 only when the lender has a certain and unconditional right to the repayment of the face value of the credit. Rotondaro derives this conclusion from the use of the word “repayment” by both the OECD Commentary (Para. 19 regarding Art. 11) and international tax literature.<sup>148</sup>

Moreover, Rotondaro supports his arguments by pointing towards the system of the OECD Model regarding passive income characterization and allocation of taxing rights. This system calls in the view of the author for a limitation of the scope of the interest article to include only income arising from contracts attributing to the investor an unconditional and certain right to redemption of the face value.<sup>149</sup> Rotondaro states 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.<sup>150</sup> With reference to the broad nature of the concept of dividends, he notes 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 a shareholder (e.g. a right to liquidation proceeds, membership of the shareholder meetings and voting rights). Moreover, Rotondaro asserts 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.<sup>151</sup> Based on this, he 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 and dividend-yielding instruments.

According to Rotondaro, the only workable distinctive criterion left between the scope of Art. 10 and the scope of Art. 11 lies in the debt claim character of the underlying receivable.<sup>152</sup> This analysis should be carried out regarding the contract giving rise to the payments or, put another way, the source of the payments. He finds that the use of the word “repayment” in Para. 25 of the OECD Commentary to Art. 10 should be seen as the final confirmation of the view that repayment certainty is a condition sine qua non with regard to interest classification, and thus with regard to the interest-dividend distinction. The statement in Para. 19 of the OECD Commentary to Art. 11, under which interest on convertible bonds fall within the scope of Art. 11 until the time of conversion, is said to be based on the certainty/uncertainty of the

investor’s entitlement to redemption.<sup>153</sup> Rotondaro states:<sup>154</sup>

Before the exercise of the conversion right, the holder of the convertible bond is fully and unconditionally entitled to the redemption of the face value thereof, regardless of the profitability of the issuing enterprise. After the conversion, the holder loses the mentioned unconditional redemption right which was previously granted to him pursuant to the regime of the convertible instrument. It is exactly the loss of this unconditional (and independent of the profitability of the issuing company) entitlement to redemption, which, after the conversion, prevents the application of Article 11 to the proceeds received by the holder of the security.

The position of Rotondaro was recently supported by Fehér,<sup>155</sup> who 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 Art. 11 of the OECD Model should be interpreted autonomously, the term “debt claim” should be developed further. Fehér specifies the following attributes that make possible the distinction between interest and dividends:<sup>156</sup>

- (1) a claim should involve a legally enforceable claim (rather than the term “absolute and unconditional right to redemption” as recommended by Rotondaro);
- (2) the amount and calculation of the yield need not have reflect a “classic” debt (fixed rates);
- (3) it is not necessary that the claim be secured or that rank before the claims of others. However, in the case of subordination, the interest must reflect the greater risks involved;
- (4) the claim must be genuine, not only from a legal perspective, but also an economic perspective;
- (5) the economic risks involved must generally reflect those of a “debt claim” and not those of “equity”.

The arguments presented above may also affect the treatment of perpetuities under income tax treaties. Basically, the relevant analysis is whether perpetual debt instruments can be said to hold an unconditional and certain right to redemption, and if a perpetual instrument does not express a claim in accordance with private law. Based on the specific attribute mentioned under (4), Fehér states the following regarding perpetual and supermaturity instruments: “Therefore, a ‘perpetual’ loan would probably not fulfil the criteria of a claim, and nei-

145. See Rotondaro, note 141, at 258.

146. Id. at 264.

147. Id. at 265.

148. An objection can be made that the sources cited 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 classified as dividend, i.e. when the profit participating bonds effectively share the risk run by the debtor company.

149. See note 148.

150. Rotondaro, note 141, at 265.

151. Id. at 266.

152. Id.

153. Id. at 267; Lang, note 117, at 145.

154. Rotondaro, note 141, at 267.

155. See Fehér, in *Conflicts of Qualification in Tax Treaty Law*, Burgstaller and Haslinger (eds.) (2007), at 227, 242.

156. Id. at 245.

ther would a loan with a term so long, which reduces the present value of the claim to almost zero".<sup>157</sup>

Clearly, it cannot be foreseen how this question will be resolved by the 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.

If the debt claim test is applied, the relevant question is whether perpetuals can be said to actually express a debt claim or to grant the holder an unconditional right to redemption.

In line with the analysis above regarding Danish law (see 3.4.), it can be argued that a perpetual instrument does in fact represent a right to redemption for the holder, even though the actual redemption may never take place. This argument is supported by the position of Vogel, who states that the term "debt claims" should be understood in its broadest sense.<sup>158</sup> Moreover, the argument is supported by the German opinion regarding perpetuals (*Ewige Anleihen*) which regards these as debt claims under Art. 11 of the OECD Model.<sup>159</sup> Seemingly, the basis for this conclusion is still an existing – albeit postponed – obligation of repayment of the loan. However, it is reported that the dividend provision in some German treaties would apply in cases where the instrument also includes a profit participation.<sup>160</sup> Support is also found in a 1992 UK decision of the Special Commissioners which held that a payment of interest under perpetual debt (also known in the United Kingdom as "equity notes") was interest rather than dividends under the applicable treaty, and also that it was not a distribution under the prevailing UK definition.<sup>161</sup> This led to tax arbitrage,<sup>162</sup> which in turn led to the introduction of specific legislation that reclassified yield on equity notes to distributions.<sup>163</sup>

Further, some interpretative support can be said to exist in the interpretation of the Interest and Royalty Directive. The reasoning here is that the Directive clearly relies on the tax treaty definition of interest, and contains a specific provision to exclude perpetual debt instruments and super-maturity debt instruments from the benefits of the Directive.<sup>164</sup> An *e contrario* interpretation should lead to the conclusion that in the absence of this specific provision in Art. 4(1)(d), such instruments would fall under the scope of the interest definition. A similar interpretation of Art. 11 of the OECD Model seems reasonable to expect from EU countries. Finally, support is found in the US literature cited in 3.2., criticizing equity classification of perpetual instruments and super-maturity instruments, and arguing in favour of debt classification.

In conclusion, remuneration on perpetual instruments and super-maturity instruments cannot be regarded as dividends from a tax treaty perspective. Moreover, there are sound arguments in favour of treating such payments as interest payments under Art. 11 of the OECD Model.

However, a definitive conclusion cannot reasonably be drawn. If actual payments do not fall under the interest definition, the corporate rights test becomes relevant. If, however, the payment does not fulfil this test either, the income would have to be classified as something else (e.g. business income, other income or capital gains).<sup>165</sup>

## 6. Conclusion and Perspectives

The use of perpetual instruments and super-maturity instruments is increasing and is now used in both the corporate sector and the financial sector. The tax law consequences thereof are an important factor in this regard. This article has introduced the economic, legal and rating framework surrounding these instruments. It is beyond doubt that perpetual instruments and super-maturity instruments serve financial objectives. Accordingly, it is important that tax legislation in the jurisdictions involved not impede the use of such instruments. The analysis has shown that domestic law governing the instruments can vary, which in cross-border transactions may lead to legal uncertainty as a consequence. US law classifies perpetuals as equity, while German law classifies the instruments as debt for tax purposes. The situation under Danish law is not clarified by the courts or tax legislation. The authorities insist on classifying the instruments as something other than debt. However, strong arguments can be put forward to contradict this.

Under the Interest and Royalty Directive, it is for the Member States to decide whether the benefits of the Directive should apply to the remuneration on perpetual instruments and super-maturity instruments. The analysis has shown that such payments are not automatically granted the benefits of the Parent-Subsidiary Directive unless the payment is in fact reclassified to dividends. From the perspective of income tax treaties, it is concluded that as a main rule the remuneration on perpetual instruments and super-maturity instruments does not qualify as a dividend. Interest treatment seems more likely, irrespective of the indefinite or extremely long-term maturity of the instruments.

157. Id. at 245.

158. See Vogel, note 117, at 732, m. 59.

159. See Briesemeister, note 66, at 407.

160. Id.

161. For a description of the UK development, see Tiley, in *Tax Treatment of Financial Instruments*, Michielse (ed.) (1995), at 310 et seq.

162. See HC Standing Committee B, 30 June 1992 col 439/440.

163. See TA 1988 Sec. 209 (9), added by F (No. 2) A 1002, at 31.

164. See Art. 4(1)(d) Interest and Royalty Directive.

165. See to this effect, see Fehér, note 155, at 246; Rotondaro, note 141, at 268 et seq.