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Debt-flavoured Equity Instruments in International Tax Law

Jakob Bundgaard*

Debt and equity can be structured to resemble one another through hybrid financial instruments. In this contribution the emphasis is on the tax issues related to debt-flavoured equity instruments in international tax law. This most important example of such instruments is preference shares. The article introduces the financial construction of preference shares and presents the rationale behind the existence hereof. As the main contribution the article presents an analysis of the international tax law aspects of preference shares, which includes a comparative overview, emphasizing the domestic tax classification and treatment in the United States, Germany, and Denmark. Moreover, the classification and treatment according to EU tax directives and double tax treaties is presented.

I BACKGROUND

Within the fascinating world of financial engineering debt and equity can be structured to resemble one another. In the contribution the emphasis is on the tax issues related to debt-flavoured equity instruments in international tax law. This most important example of such instruments is preference shares. Shares may be designed to include one or several features which are characteristics typically found in debt. Such shares are commonly referred to as preference shares or preferred shares ('vorzugsanteile' in German).¹ Preferred shares can sometimes be structured as functional equivalents to debt.²

Preference shares were first issued by Maryland road and canal companies in the US in the 1830s. Since then the practice spread to US railroads in the 1840s and 1850s to finance construction projects. The railroad companies were financially distressed. These shares allowed fixed dividends.³

Today preference shares are commonly used in public and private transactions and it may be argued that such instruments are not perceived to be nearly as exotic as other types of hybrid financial instruments.⁴

2 FINANCIAL CONSTRUCTION

While the investor investing in preference shares is a member of the issuing company, the security will normally carry with it a number of 'quasi-debt' benefits.⁵ As a result although preferred equity is risk capital, the investor is ensured a certain cut of distributed profits.

Preference shares may have a variety of different attributes.⁶ In general preference shares allow a preferable treatment of the holder with respect to economic rights while being granted only few or none decision rights in the company. The holder may be granted a favourable position with respect to receiving dividends or liquidation

Notes

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¹ See e.g., *Tirole*: The Theory of Corporate Finance, 2006, p. 76. *Coyle*: Hybrid Financial Instruments, 2002, p. 82 describes preferred stock as not being equity.

² Cf. *Edgar*: The Income tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50. In fact certain issues of preference shares have been described as having modelled as convertible bonds, cf. *Riskworx*: The Anglo Platinum Preferences Shares Modelled as Convertible Bonds, 2004, regarding a 204 South African preference shares issuance.

³ See *Evans*: The Early History of Preferred Stock in the United States, *American Economic Review*, 1929 and *Laurent*: Securities that to the deal: The decision to issues preference shares by UK firms, 2006, p. 2.

⁴ A recent example is the issuance of preference shares by Goldman Sachs with Warren Buffet as the investor. In *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11, preferred shares are stated to be the most common form of hybrid equity. Preference shares are found to be the second most commonly used type of hybrid securities, cf. *Deutsche Bank*: The Theory and Practice of Corporate Debt Structure, 2006, p. 37. See moreover *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 244, stating that the importance of preference shares for banks should still rise in order to prospectively become compliant with Basel III and hereby particularly with the additional Tier 1 capital requirements.

⁵ See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11.

⁶ See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 11, *Laurent*, *ibid.*, p. 5, *Hey* in Hybrid Financing, 1993, p. 104, *Coyle*: Hybrid Financial Instruments, 2002, pp. 82 et seq., *Helminen*: The International Tax law Concept of Dividend, 2010, pp. 198 et seq., *Lamon* in DFI 2002, 58, *Ferran*: Company Law and Corporate Finance, 1999, p. 53 and *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, pp. 244 et seq.

proceeds. The dividends may even be fixed. Dividend payments may be cumulative or non-cumulative (cumulative or non-cumulative preference shares). The shares may be mandatorily redeemable by the issuing company whereby the shareholder may demand redemption from the issuing company or the company may be allowed to demand a repurchase of shares (mandatory redeemable preference shares) after a number of years or maybe the shares are irredeemable. Convertible shares may also be convertible into other classes of share capital or even into debt (convertible shares).⁷ Moreover, preference shares may exclude voting rights (non-voting preference shares) or include limited or full voting rights.

As mentioned preference shares can be conventional, cumulative, participating, redeemable and convertible.⁸ Cumulative preferred shares entitle their holder to a fixed rate of dividend, and if any dividend is unpaid, the arrears of dividend remain payable and accumulate. The preferred shareholders must receive their arrears of dividend before any ordinary dividend can be paid to other shareholders. Participating preference shares have extra dividend rights and allow holders in addition to their fixed dividend to also participate in the company's surplus. Redeemable preferred stocks are shares that either will be redeemed at a specified future date, or could be redeemed at a specified date, at the option of either the company or the shareholders. Convertible preferred stocks give their holder the right to convert their stock into ordinary shares of the company, at a specified future date or between specified future dates, at a specified rate of conversion.

Depending on the attributes of the preference shares, they can be viewed along a spectrum from quasi-debt to quasi-equity instruments.⁹ Accordingly depending on the attributes of the preference share in question there may be only a slight difference between PPL's and e.g., cumulative non-voting preference shares.¹⁰ However, empirical studies suggest that preference shares are primarily considered an alternative to ordinary shares.¹¹

3 THE FINANCIAL DECISION TO ISSUE AND INVEST IN PREFERENCE SHARES

From the perspective of the issuer it may be more attractive to raise money by equity, rather than debt issue since issuance of preference shares is likely to be cheaper in terms of coupon and will normally have a positive impact on the issuer's gearing ratio.¹² The case for preference shares has also been described as situations where companies need equity investors with entrepreneurial risk, but where the companies do not want to give the investors control in the company.¹³

Traditionally the case for preference shares is that they are issued by financially distressed companies. Existing capital structure theories concentrate on the attributes of equity and debt and do not in general consider hybrid financial instruments.¹⁴ *Laurent* has analysed whether the existing capital structure theories relating to straight debt and equity can explain the use of preference shares and convertible debt in the UK. *Laurent* tested the theories of taxation, bankruptcy, agency costs, and pecking order. One result was that some support could be expressed to the theory, according to which the firms with high volatility of earnings uses less debt in their capital structure if preference shares are assumed to be substitutes for equity and convertible debt as substitutes for debt. In addition the analysis supported other findings stating that taxation plays a minor role in the financing decision. However, *Laurent* was unable to rationalize the use of hybrid financial instruments based on capital structure theories based on the evidence provided by the empirical investigation.¹⁵

According to *Bärsch*, the economic functions of preference shares are *that* they allow the investor an effective way to exit its investment, *that* the liquidity outflow is more cash-flow oriented from the issuer's perspective and *that* convertible preference shares may be attractive for investors who could seek a classification as equity for financial accounting purposes.¹⁶

Notes

⁷ *Nørgaard & Werlauff: Vedtægter og aktionæroverenskomster*, 1995, p. 170.

⁸ *Coyle: Hybrid Financial Instruments*, 2002, p. 83.

⁹ See *Laurent, ibid.*, p. 5.

¹⁰ Cf. also *Helminen: The International Tax law Concept of Dividend*, 2010, p. 199, emphasizing that from an economic perspective, there is not much reason for distinguishing between the tax treatment of debt and preferred non-voting redeemable shares.

¹¹ See *Laurent, ibid.*, p. 27.

¹² See *McCormick/Creamer: Hybrid Corporate Securities: International legal Aspects*, 1987, p. 13.

¹³ See *Helminen: The International Tax law Concept of Dividend*, 2010, p. 199.

¹⁴ See *Laurent: Capital Structure Decision: The Use of Preference Shares and Convertible Debt in the UK*, 2001, pp. 3 et seq.

¹⁵ *Ibid.*, p. 36.

¹⁶ *Bärsch: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context*, 2012, p. 245.

Given the fact that preference shares are essentially equity type instruments such instruments are often regulated by domestic company laws which is rarely the case for hybrid debt instruments.

As an example preference shares are often used in the venture capital industry where multiple categories of investors are involved.¹⁷ The investor in preferred equity is able to preserve the ability to participate in future gains through appropriate conversion rights while, in the meantime, maintaining a fixed income and some degree of protection through preferential rights on a return of capital.¹⁸

Preferred instruments are also seen in the private equity industry where the so-called carried interest in fact allows the holder a preferred return on investment.¹⁹ Carried interest is a business standard regarding the remuneration of partners/managers in private equity funds and venture capital funds. Such funds are most commonly structured via partnership structures either directly or through personal holding companies of the partners. Carried interest payments result in a distribution of the economic return on the investment which does not match the invested capital. Typically a 20% yield is obtained according to the carried interest mechanism if a hurdle rate of IRR 8% has been met at an initial investment of 1%–2%. Since carried interest mechanisms often refer to participation in partnerships the following shall not address this any further.

Well-known US examples of preference shares are PERCS (Preferred Equity Redemption Cumulative Stock), PRIDES (Preferred Redeemable Increased Dividend Equity Securities) and DECS (Dividend Enhanced Convertible Stock). PERCS are preferred shares which offer limited upside participation with the underlying stock and mandatorily convert into common stock at maturity.²⁰ PRIDES are preferred shares which mandatorily convert into common shares at maturity.

Other examples include Redeemable Preference Shares (RPS) and Mandatory Redeemable Preference Shares (MRPS) are instruments often used in several private transactions.²¹

4 TAX TREATMENT OF PREFERENCE SHARES IN DOMESTIC TAX LAW

4.1 Comparative Overview

For accounting purposes according to IAS 32 ordinary preference shares are considered equity instruments. However, preferred shares that pay a fixed dividend and that have mandatory redemption feature at a future date are classified as liabilities because the substance is that they are a contractual obligation to deliver cash.²²

Most countries seem to classify preference shares as equity for tax purposes.²³ In general terms the tax treatment of debt seems to be favoured over equity. Consequently, the need for reclassifying equity as debt for tax law purposes is not as great as the need for reclassifying debt as equity.²⁴ Such a need is primarily seen where the scope of participation exemption regimes or foreign tax credit regimes are at stake.

Certain countries have introduced specific rules targeted on preference shares. This includes Canada which has introduced such rules in 1987 with the purposes of taxing dividends from preferred shares.²⁵ Similarly such rules were introduced in Australia in 1987. The legislation has the intent of preventing the substitution of tax-free dividends for taxable interest income.²⁶ Australia has been widely known for the possibilities to issue certain types of redeemable preference shares which allow deductibility of dividend payments. Thus, particular redeemable preference shares can fulfil the debt test according to

Notes

¹⁷ See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 12.

¹⁸ See *McCormick/Creamer*: Hybrid Corporate Securities: International legal Aspects, 1987, p. 12.

¹⁹ See *Lambert Meier*: The Carried Interest Controversy: The U.S. and U.K. Reform Movements of 2007, TNI 2008, 21 Apr. 2008, pp. 255 et seq., *Aron-Dine*: 'An Analysis of the Carried Interest Controversy', Center on Budget and Policy Priorities, 2007, *Sanchirico*: Tax Tax Advantage to Paying Private Equity Fund managers with Profit Shares: What Is It? Why Is It Bad?, The University of Chicago Law Review, 2008, p. 1072 et seq., and *Anziger & Jekerle* in IStR 2008: Entwicklungen in der Besteuerung des Carried Interest in Deutschland, Grossbritannien und den USA – Denkanstöße aus der neuen Welt?, p. 821 et seq., *Okamoto & Brennan*: Measuring the Tax Subsidy in Private Equity and Hedge fund Compensation, Drexel University College of Law, Legal Studies Research Paper Series 2008-W-01.

²⁰ See *Coxe* in Nelken (ed.): Handbook of Hybrid Instruments, 2000, p. 31 et seq.

²¹ Typical legal terms of MRPS are ten years maturity, no voting rights, right to a fixed preferred dividend based on nominal value of MRPS issues, annual distribution of preferred dividend, preferential right to the reimbursement and a liquidation preference to the MRPS holder.

²² See IAS 32 and *Humphreys*: Tax Deductible Equity: The Quest for the holy grail, Tax Forum, 2006, p. 26.

²³ See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 200 and *Helminen*: The Dividend Concept in International tax Law, 1999, p. 313 regarding US law, p. 313 regarding German law, p. 314 regarding Swedish and Finnish law. See *Lamon* in DFI 2002, p. 59 regarding Belgian Law. *Edgar*: The Income tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 49 et seq. regarding Canadian law. See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, pp. 246 et seq. and p. 253. regarding Australian law, p. 248 and 254 regarding German law, p. 250 and 255 regarding Italian law, pp. 252 and 256 regarding Dutch law.

²⁴ See *Helminen*: The International Tax Law Concept of Dividend, 2010, p. 200.

²⁵ See *Edgar*: The Income Tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50.

²⁶ See *Edgar*: The Income Tax Treatment of Financial Instruments: Theory and Practice, 2000, p. 50.

Australian tax law.²⁷ This has, i.e., been confirmed in a case before the Federal Court, *Noza Holdings Pty Ltd v. Commissioner of Taxation* [2011] FCA 46.

UK case law has concluded that a preference share carrying a 5% interest dependent on the profits of the corporation was a creditor relationship similar to a debenture holder.²⁸ Specific legislation has recently been enacted in the UK regarding deemed loan relationships and disguised interest. Moreover, specific legislation has been introduced in order to deal with non-participating or fixed rate redeemable preference shares. The consequence of the rules is that, unless certain exceptions are met, any shares accounted for as a liability will be taxed as though they are a liability and the return will be taxed within the loan relationship regime.²⁹ Here it is seen that the accounting treatment will be decisive.

In Dutch law, preference shares and the yield thereon is generally respected for tax purposes in so far the civil law classification is in place.³⁰ However, two recent appeals court cases suggest that in the view of some, a reclassification of equity into debt may be justified under certain circumstances. The first case concerned redeemable preference shares in an Australian company. The characteristics of the redeemable preference shares were that: (i) they annually pay a cumulative preferred dividend of 8%, increasing to 12% of the amount contributed on the redeemable preference shares, (ii) they have basically no voting rights, and (iii) they will be redeemed within ten years.³¹ The participation exemption is applied to the income derived from the redeemable preference shares. As a consequence, although the payments on the redeemable preference shares were still deductible under Australian tax law, they were no longer taxed at the level of the Dutch taxpayer. The court case revolved around two questions, namely: (i) should the redeemable preference shares be reclassified as debt and (ii) should the application of the participation exemption be denied on the basis of the abuse of law doctrine.

The Lower Court ruled that the redeemable preference shares were in fact a loan because they had a fixed maturity of less than fifty years, a fixed interest rate which was not dependent on the profit of the Australian company and the

redeemable preference shares did not have voting rights. On appeal, however, the Court of Appeal stated that the redeemable preference shares were comparable to preference shares issued by a Dutch company to which the participation exemption would have applied.³² Therefore, the redeemable preference shares could be considered as participation within the meaning of the participation exemption provisions and as a consequence, the income was exempt. As a consequence, the use of the redeemable preference shares cannot be regarded as violating the aim and purpose of the participation exemption, and the abuse of law doctrine therefore does not apply. According to *van Gelder & Niels*, the advocate-general is quite right in dismissing the abuse of law argument, and if that argument were to be followed by the Dutch Supreme Court it would be clear that the Dutch abuse of law doctrine as such does not restrict application of the participation exemption in cases where a hybrid finance instrument is used.³³ On 7 February 2014, the Hoge Raad upheld the decision. The Hoge Raad rejected the tax authorities' position that an instrument that qualifies as equity from a legal perspective as debt for purposes of the application of the participation exemption. The Hoge Raad opined that the main legal characteristic of equity is its risk profile. In an instrument satisfies this main characteristic and otherwise qualifies as equity from a legal perspective, then the presence of other debt-like features do not result in a reclassification as debt for tax purposes. In addition, the Hoge Raad stated that the application of the participation exemption does not depend on whether the subsidiary is able to deduct the dividends paid or on the accounting treatment at the level of the parent company or the subsidiary.³⁴

In the other case regarding a bank-refinancing arrangement the Court of Appeal decided that the case at hand was within the sham transaction doctrine, as the banks designed an equity contribution, but in fact intended to grant a loan.³⁵ According to Dutch commentary both rulings are somewhat surprising, and when now followed by the Dutch Supreme Court, might have a severe impact on the application of the participation exemption to hybrid finance instruments.³⁶

Notes

²⁷ See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, pp. 246 et seq.

²⁸ See UK High Court 1954, *Inland Revenue Commissioners v. Pullmann Car Co. Ltd.* (1954) 12 TC 1159.

²⁹ See CFM45510 – Deemed loan relationships: shares accounted for as liabilities.

³⁰ See *van Gelder & Niels* in DFI 2013, pp. 140 et seq. (p. 143) and *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 252.

³¹ See *van Gelder & Niels* in DFI 2013, pp. 140 et seq. (p. 143).

³² AC Amsterdam (Gerechtshof Amsterdam), 7 Jun. 2012, 11/00174, VN 2012/40.11.

³³ See *van Gelder & Niels* in DFI 2013, pp. 140 et seq. (p. 143).

³⁴ See *Gelen & Oudemans*: Netherlands Tax Alert, 14 Feb. 2014: Supreme Court confirms treatment of hybrid instruments for participation exemption purposes.

³⁵ See *van Gelder & Niels* in DFI 2013, pp. 140 et seq. (p. 144).

³⁶ See *van Gelder & Niels* in DFI 2013, p. 140 et seq. (p. 144).

Since the date of effect in 2008 of Spanish GAAP Spanish law has allowed for the issuance of non-voting shares which must be accounted for debt.

4.2 US Federal Tax Law

Preferred shares are commonly known in the US. As a starting point preference shares in their most basic form are classified as equity for tax purposes.³⁷ However, preferred stock is a security where the blurred line between debt and equity is often tested.³⁸ The type of preferred stock and how it is structured will determine its status as debt or equity.

Redeemable preference shares may in certain cases face debt classification. Mandatory redemption features seem to particularly increase the likelihood of debt classification.

One example of preferred stock that has been treated as debt is Monthly Income Preferred Stock (MIPS). In 1993 the first MIPS (Monthly Income Preferred Shares/Securities)³⁹ were introduced in the US Market and the first transaction undertaken by Texaco Corporation. The net effect of the transaction was that Texaco was able to deduct interest on a subordinated loan and at the same time the instruments were not shown as debt on the balance sheet.⁴⁰ An MIPS transaction provides a borrower with an interest expense deduction while avoiding reporting the borrowing for financial accounting purposes. Generally a pass-through entity is set up by the borrower. The pass-through entity then issues equity interests (the MIPS) that have a debt-like return.⁴¹ The proceeds from the sale of the MIPS are lent to the borrower, thereby allowing the borrower to take an interest expense deduction. Commonly, the borrower and the pass-through entity are consolidated for financial accounting purposes, which results in the elimination of the debt and allows the

issuer to treat the MIPS as a minority equity interest in a subsidiary resulting in an increase of its capital. If the entity is consolidated with the issuer and the issuer for accounting purposes, then the debt is ignored and the issuer is treated as having issued some form of preferred interest to the public.⁴² The IRS issued a Technical Advice Memorandum in which it found an MIPS transaction to be debt.⁴³ Notice 94-47 was the Treasury Departments administrative response to the increased use of MIPS. The Treasury hereby posted 'off-limits' signs around certain transactions.⁴⁴ The IRS also analysed MIPS during an audit of a taxpayer (apparently Enron) in 1998, which resulted in the issuance of Technical Advice Memorandum 199910046. The TAM held that the issuer can deduct interest on an MIPS-like instrument.

In a recent case, the US Tax Court determined that a complex and tax driven investment structure involving preferred shares should be treated as a loan for Federal income tax purposes.⁴⁵ The conclusion was reached after thoroughly reviewing the debt-equity factors in detail.

4.3 German Tax law

Preference shares are commonly known and widely used in Germany.⁴⁶ Preference shares issued according to German company law (Sections 12 Abs. 1 S. 2, 139–141 AktG) are considered regular equity instruments and the preference shareholders are considered members of the corporation. The shares carry membership rights with the exception of voting rights. Issuance of preference shares with voting rights is possible but rare.⁴⁷ Preference shares are issued with a cumulative preference with respect to dividends.

Preference shares are generally respected as equity in German tax law and there are no specific provision

Notes

³⁷ See *Hammer* in DFI 1999, p. 340. It seems that venture capital backed firms are financed through convertible preferred stock, cf. *Gilson & Schizer*: Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock, Stanford Law School, John M. Olin Program in Law and Economics, Working Paper No. 230. The authors explain this fact by pointing at the more favorable tax treatment for incentive compensation paid to the entrepreneur and other portfolio company employees by way of transmuting ordinary income into deferred capital gain.

³⁸ See *Hammer* in DFI 1999, p. 340 and *Haun*: Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steuerrecht, 1996, pp. 195 et seq.

³⁹ MIPS is just the trademark name from one Investment Bank. Other names for similar products or progeny products are: TOPrS, QUIPS, QUIDS, TECONS, ACES, ENHANCED PRIDES, TRUPS (being exchangeable MIPS).

⁴⁰ *Humphreys* in PLI/Tax, 2006, pp. 379 et seq. (p. 398), *Garlock*: Federal Income Taxation of Debt Instruments, 2006, pp. 1030 et seq., *Connors & Woll* in PLI/Tax, 2002, pp. 16 et seq., *Freeman, Stevens & Hollender* in 734 PLI/Tax, 2006, pp. 861 et seq. (p. 866-873), *Hammer* in DFI 1999, p. 340.

⁴¹ MIPS has been found in many variations and are generally known as trust preferred securities. Thus, reverse MIPS, Debt MIPS, Convertible and Exchangeable MIPS are found.

⁴² See *Garlock*: Federal Income Taxation of Debt Instruments, 2006, p. 1030.

⁴³ TAM 199910046, the same result is reached by *Humphreys* id. and *Garlock*: The Taxation of Debt Instruments, 2006, pp. 1031 et seq.

⁴⁴ *Humphreys*, at p. 402.

⁴⁵ T.C. Memo. 2012-135 *Hewlett-Packard Company and consolidated Subsidiaries*.

⁴⁶ See *Jacob* in *Cahiers*, 2000, p. 316, *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, pp. 152 et seq., and *Bowitz & Heinrichs* in *Maisto* (ed.): Taxation of intercompany Dividends under tax Treaties and EU Law, 2012, p. 567.

⁴⁷ See *Bowitz & Heinrichs* in *Maisto* (ed.): Taxation of intercompany Dividends under tax Treaties and EU Law, 2012, p. 567.

governing the taxation of preference shares.⁴⁸ The generally applicable principles regarding equity classification of *genussrechte* also applies to the classification of preference shares.⁴⁹ As a consequence the remuneration on preference shares is non-tax deductible for the purposes of German corporate income tax and local business tax. Remuneration on preference shares qualify as dividend according to German tax treaties due to the autonomous definition and the reference to domestic tax classification in Germany.⁵⁰ No cases of reclassification into debt for domestic tax purposes have been reported.⁵¹ Reclassification, however, cannot, be ruled out with respect to such preference instruments which resemble profit participating debt more than equity.

4.4 Danish Tax law

Preference shares can be issued according to Danish company law. Early issuances of preference shares included non-voting shares with a fixed cumulative dividend payment and shares without right to liquidation proceeds if the total repayment would exceed par value.⁵² A recent Danish company law reform was based on the reasoning that financing decisions are not a simple choice between debt and shares but a wide range of different instruments where rights and obligations for the issuing company and its investors are accommodated to the needs and risk position of the parties.⁵³ Consequently, according to the expert panel company law should not create obstacles for the desirable financing and investment decision which the parties agree. Based on this reasoning non-voting shares were reintroduced in Danish law in 2010 and the wide possibility to issue preference shares in a variety of forms was reiterated.

Preference shares which are actually issued in accordance with company law procedures should be accepted for Danish tax law purposes and treated as other shares for tax law purposes. Preference shares have been widely used in practice to ensure generational changes and used to fulfil formal ownership criteria (e.g., the 10% participation exemption threshold).⁵⁴

In general, preference shares are recognized in Danish tax law as being shares and the remuneration as dividends. Case law supports a conclusion according to which the substance over form doctrine does not apply to transactions which are governed by company law. This conclusion should even apply to non-voting cumulative preference shares and mandatory redeemable preference shares. However, the question cannot be answered in general, since an actual assessment of the preference shares in question should be made.

The debt/equity distinction has drawn only little attention in Danish tax law. When Danish companies are involved as issuers of securities the investment is qualified according to formal rules in Danish company law.

In general, there are very few examples of tax law reclassification of formal equity into debt or even reclassification from dividends to interest payments. Shares issued by Danish companies are in general defined by way of reference to the formal company law registration system. If a share is registered as such with the Danish Business Authority it should be qualified in the same way for tax law purposes.⁵⁵ Once the registration is made the courts have been more dismissive regarding the reclassification of companies which have been formally registered even on the basis of wrong information.⁵⁶ It is generally accepted in theory and practice that the notion of share capital should be qualified in the same way for company law and tax law purposes. As a result hereof tax payers have been denied tax deduction regarding losses on shares if the shares were not registered as such for company law purposes.

In Tfs 1990.240 LSR formal equity was disregarded. A Danish subsidiary of a Swiss parent company in February 1985 subscribed shares through a capital increase in a US sister company. The cash contribution was financed by postponing an already planned construction activity. Simultaneously with the share subscription the company and its parent company entered a contract granting the parent company a right and an obligation to acquire the shares to the price initially paid. The shares were acquired in 1986 by the parent company. The National Tax Tribunal found that the funds were in fact a loan to the

Notes

⁴⁸ See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p.152, *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 248 et seq. and *Høy* in *Hybrid Financing*, 1993, p. 104: 'Preferred dividends are afforded dividend treatment like any other ordinary dividend under national law for purposes of tax treaties and the EC parent-Subsidiary Directive'.

⁴⁹ See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, p. 152.

⁵⁰ *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 249.

⁵¹ See *Briesemeister*: Hybride Finanzinstrumente im Ertragssteuerrecht, 2006, pp. 153-154 and *Helminen*: The Dividend Concept in International Tax Law, 1999, p. 313.

⁵² See *Berning*: Finansieringsret, 1977, pp. 162 et seq.

⁵³ See *Betænkning* 1498, 2009, p. 175.

⁵⁴ See e.g. SKM 2003.134 LR (dividend preference), SKM 2005.549 LR (dividend preference), SKM 2008.360 SR, SKM 2008.600 SR and SKM 2010.631 SR (interest bearing share without economics rights).

⁵⁵ See Tfs 1996, 603 V and Tfs 1984, 189 Ø, not allowing the tax payer a loss deduction on shares acquired on the basis of a capital increase which was not formally registered.

⁵⁶ See LSRM 1942, 15, LSRM 1947, 2, and Tfs 1989, 68 H.

parent company, based on the reasoning that the funds of the Danish subsidiary as a consequence of the parent company's influence over the Danish company were used to the benefit of the financially distressed US company. As a consequence the Danish company was taxed on the basis of an arm's length interest according to SL section 4.⁵⁷ Albeit the decision concerns the question of taxation of deemed interest income and the arm's length principles the reality is that the decision expresses a disregard of formal equity into a loan.

Besides the case presented above, the closest we get to a reclassification of equity seem to be the High Court decision in TfS 2003.889 H. The decision was however later reversed by the Supreme Court.⁵⁸ The High Court denied interest deductibility in a financing transaction aiming at utilizing losses carried forward on the basis of a substance over form line of thinking. The decision was based on a close relationship between obtaining a loan, an increase of capital and a subsequent capital reduction. Based on this fact pattern the court did not find that the company has substantiated a real right to dispose over the funds advanced by the loan and that a loss making company did not have a real right to dispose over the funds advanced as equity. The High Court found that the funds from the loan were predetermined to be used to on-lend to a group company. Moreover, the court found that the loans were not giving rise to a real risk for the companies involved and that the transactions did not serve a business purpose. In total the loan was disregarded for tax law purposes. As it is seen the disregard of company law formalities only occurs indirectly as a consequence of the disregard of the loan. To reach this result the High Court must have found that the actual capital increase of the other company was not carried out or in fact carried by another company irrespective of the fact the company in question did subscribe for shares in the capital increase process. As already stated *supra* the Supreme Court reversed the decision based on the reasoning that the procedure engaged in by the companies was a legitimate planning technique based on an explicit statement regarding financial loss making companies in the then applicable LL section 15, paragraph 7(3).

The aftermath of the Finwill-decision analysed *supra* is that there is only very limited support – if any at all – in existing case law in favour of reclassification of a formally existing equity investment. Most recently the same conclusion was implicitly upheld by the Danish Eastern High Court in SKM 2012.534 Ø. One remaining

question, however, is whether the conclusion is also generally applicable with respect to reclassification of dividend payments. A crucial question is whether a declared dividend for company law purposes can be classified differently for tax law purposes. To answer this it should be assessed whether the notion of a dividend for tax law purposes is tied up to the company law notion of a dividend and whether declared dividends can be said to exist only as a consequence of the company law legislation. The tax law notion of dividends in LL section 16 A is broader than declared dividends for company law purposes. Thus, the tax law concept of dividends includes disguised dividends. This fact does not however imply that the notion of a dividend for tax law purposes can be understood in a narrower sense than to cover at least all declared dividends.⁵⁹

Based on case law it seems possible at least in certain cases to reclassify dividend payments into other categories of income for tax law purposes.

Reclassification of dividend payments to interest payments is seen in TfS 1985.324 LR regarding preference shares. The National Assessment Board was asked to confirm whether payments received from a newly formed Irish financing company would qualify for exemption in Denmark according to Article 6 of the Denmark-Ireland Double Tax Convention. An Irish company wanted to increase its activities in Denmark and a part of these considerations involved the formation of a new Irish company with a share capital of USD 8,000,100. The share capital should be divided into shares of a nominal value of USD 100. The remaining USD 8,000,000 should be preference shares, without voting right. The preference shares should be sold to another Danish company. The Irish company would then on-lend the money to the Irish parent company with the intent to purchase an aeroplane, which should then be leased out. At the same time the Irish parent company guaranteed to the holders of the preference shares (including the Danish holders) that the preference shares during the term of the leasing contract, could be sold to a third party at par value plus dividends not yet paid out. The Irish financing company could anticipate a fixed income from the loan to the Irish parent company and consequently could pay out fixed dividends to its shareholders. The terms were known by the holders of the preference shares in advance.

The National Assessment Board decided that the payments should not be considered dividends covered by the Denmark-Ireland Double Taxation Convention. It was

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⁵⁷ See for commentary *Michelsen* in R&R 1991 SM, pp. 144 et seq., questioning whether the Tax Tribunal would have reached the same conclusion if there was no agreement to sell shares to the parent company, even though that the parent company could force such a sale through.

⁵⁸ See for commentary *Michelsen* in R&R 2004 SM, pp. 2. et seq., *Severin Hansen* in TfS 2004, 88, *Guldmand Hansen* in SR-Skat 2004, pp. 50 et seq., and *Bundgaard & Møllin Ottosen* in ET 2008, pp. 59 et seq.

⁵⁹ See in general on classification of dividends *Byskov* in TfS 1999, 193.

not directly stated that the income was instead interest income, but this it generally thought to be the case.⁶⁰ The Board emphasized the following to support the decision:

- that the preference shares did not have a right to vote;
- that the dividend could be calculated in advance;
- that the shares could be sold at par value;
- that accrued dividends should be paid if the shares were sold;
- that the paid in capital was determined for a loan to the parent company.

The decision does not provide any general guidelines regarding the classification of hybrid financial instruments for domestic Danish tax law. It should moreover be noted that the binding ruling is more than twenty-five years old and does not arise from a Danish Court. Moreover, the case concerns the interpretation of a tax treaty and is based on the actual facts of the case in question. Further it may have played a role that Article 6 of the then applicable Denmark-Ireland treaty should be interpreted in a way that both countries did not tax dividends and that the method of double taxation relief according to Article 23 was the exemption method. Thus, as a result of the treaty the dividends would not be taxed at all.⁶¹

Recently the question was more generally raised in a ruling in SKM 2007.199 SR. The Tax Board was asked to decide whether dividends paid prior to a subsequent sale of shares could be reclassified to cash payment for the sale of shares. The dividends would be tax exempt in the hands of the recipient according to SEL section 13, paragraph 1(2). The tax payer referred to the Finwill-decision. The Tax Board, however, found that irrespective of the Finwill-decision it is possible to classify dividends different from the company law classification, but did not find any reason to do so in the actual case.⁶²

In SKM 2010.141 SR dividends were reclassified into salary income. The dividends replaced previous salary payments to the tax payer in question and moreover the answer was given as a specific request by the tax payer who asked the Tax Board to confirm that this was the correct tax classification for Danish tax purposes.

There is no basis to reclassify dividends on the basis that the dividend is deductible at the level of the paying entity. This is confirmed by the specific provision in SEL section 13(1)(2) disallowing participation exemption if the paying company can deduct the payment.

5 EU CORPORATE TAX LAW DIRECTIVES

The PSD will be the natural starting point when considering the taxation of income from preference shares in European Union tax law. The IRD should, however, not be applicable to yield from preference shares since preference shares do not fulfil the autonomous interest test definition of the IRD.⁶³

Preference shares that form part of the subsidiary's capital is similar to any other shares. The directive does not describe the term 'capital' as used in Article 3(1) further, but the directive does not distinguish between different types of capital. Moreover, the term 'capital' is understood to include not only actual shareholdings, but also hidden equity capital. As stated by Thömmes, the commentary to Article 10 of the OECD Model may be used as an aid for interpretive purposes.⁶⁴ However, further refinements resulting from the future practice of the ECJ cannot be ruled out.⁶⁵

The general opinion among legal commentary seems to be that the benefits of the PSD should also as a starting point be granted to dividends from preference shares.⁶⁶ As a possible limitation to this *Helminen* has stated that the application of the directive should not be required if the economic nature of a payment is not a distribution of profits but rather a payment of interest.⁶⁷ From the perspective of the state of residence of the subsidiary there is hardly an incentive to reclassify the dividend payments into interest payments. This might change from the perspective of the state of residence of the parent company.

Whether or not this is allowed for the Member State of the parent company depends on whether or not the underlying transaction can be considered abusive in the sense laid down in Article 1(2) of the directive. As I have analysed elsewhere the conclusion is that Member States cannot reduce the scope of the PSD by way of

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⁶⁰ See SpO 1985, p. 135.

⁶¹ See *Michelsen* in R&R 1991 SM 144.

⁶² *Bjørn* criticizes the decision in SR-Skat 2007, pp. 84 et seq. A similar result is however reached in SKM 2007, 488 SR regarding dividend payments after a tax free merger. The Tax Board presupposes a possibility of reclassifying dividends to cash payments in the transactions.

⁶³ See *Bärsch*: Taxation of Hybrid Financial Instruments and the Remuneration Derived Therefrom in an International and Cross-border Context, 2012, p. 249 from the perspective of German law.

⁶⁴ See *Thömmes* in EC Corporate tax Law, Binder 1, 1992, p. 35, para. 35 to Art. 3 of the PSD. It is stated that the Commission itself referred to the relevant section of the commentary (para. 15 to Art. 10 of the OECD Model) when asked for an interpretation of the term 'capital' during the Councils discussions.

⁶⁵ See *Thömmes* in EC Corporate tax Law, Binder 1, 1992, p. 35, para. 35 to Art. 3 of the PSD.

⁶⁶ *Helminen*: The International tax Law Concept of Dividend, 2010, p. 201.

⁶⁷ *Ibid.*

reclassification of the yield from HFIs, including preference shares.⁶⁸ Supportive of such a broad interpretation of the PSD is that the directive seems to include yield from equity-like debt instruments to fall within the ambit of the PSD. Based on this the directive should even more so include under its scope dividend payments from preference shares.

It is my opinion that the scope of the PSD cannot be reduced on the basis of deductibility of the yield in the Member State of the paying company. Since it is not expected that ECJ will apply a teleological interpretation to reduce the scope of directives, a literal interpretation should prevail in this context. A reduction of the scope of the directive should be based on specific provisions in the directive allowing this. The only option is to apply the fraud and abuse provision in Article 1(2) of the PSD. However, tax arbitrage does not as a general rule constitute an abusive practice. Contrary to this *Helminen* concludes the following in this respect: ‘...in the case of wholly artificial tax avoidance arrangements where there are no business reasons for the use of preferred shares instead of debt, the benefits do not have to be made available...’.⁶⁹ Based on the available interpretive sources I see no legal basis to include a business motive test in the PSD.

It is concluded that the scope of the PSD cannot be reduced on the basis of deductibility in the Member State of the paying company. Since it is not expected that ECJ will apply a teleological interpretation to reduce the scope of directives a literal interpretation should prevail. A reduction of the scope of the directive should be based on specific provisions in the directive allowing this. The only option is to apply the fraud and abuse provision in Article 1(2) of the PSD. However, it is concluded that tax arbitrage does not as a general rule constitute an abusive practice. The most recent proposal of the Commission for an amendment of the PSD Article 4 seems to confirm such an interpretation of the currently applicable directive. According to the proposal participating exemption should not be granted with respect to dividend payments which are deductible in the state of the paying company (*‘refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary of the parent company’*).⁷⁰

According to *van Gelder & Niels*, an amendment of the PSD that requires Member States to deny participation exemption may be in conflict with the principle of sovereignty in tax matters if a Member State does not want to tax in that situation.⁷¹

6 DOUBLE TAX TREATIES

In the context of double tax treaties, the yield on hybrid financial instruments may classify as dividend payments under Article 10, as interest payment under Article 11 or as other income under Article 21 in double tax treaties agreed on the basis of the OECD Model Tax Convention.⁷² Moreover, Article 7 and Article 13 of treaties based on the OECD Model may be of relevance. For the sake of simplicity, only the dividend provision and the interest provision are analysed in the following with respect to preference shares. The demarcation is of great importance since the taxing right under the treaties differs depending on the type of income.

The term ‘capital’ as used in Article 10(2)(a) of the OECD Model should also include preference shares since capital is understood as it is understood in company law.⁷³

With respect to companies (i.e., non-transparent companies according to Article 3(1)(b)) it may be assumed that the relevant treaty provisions are Article 10 and Article 11 of the OECD model.⁷⁴ The classification of yield on preference shares for tax treaty purposes relies on the generally applicable tests, i.e., the corporate test and the debt claim test.⁷⁵

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

The term ‘dividends’ as used in this Article means income from shares, ‘jouissance’ shares or ‘jouissance’ rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.⁷⁶

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⁶⁸ See *Bundgaard* in ET 2010/10, pp. 442–456 and ET 2010/11, pp. 490–500.

⁶⁹ *Ibid.*, p. 202.

⁷⁰ See COM(2013) 814 final. Apparently the proposal does not apply to dividend payments which are deductible at a lower tier than the immediate subsidiary.

⁷¹ See *van Gelder & Niels* in DFI 2013, p. 147.

⁷² See in general *Köhler* in Piltz/Schaumburg (eds.): *International Unternehmensfinanzierung*, 2006, 137 et seq., *Six: Hybride Finanzierung im Internationalen Steuerrecht am Beispiel von Genussrechten*, 2007, pp. 94 et seq., and *Briesemeister: Hybride Finanzinstrumente im Ertragssteuerrecht*, 2006, pp. 393 et seq.

⁷³ See para. 15 to Art. 10 of the OECD Commentary.

⁷⁴ If the issuing company on the other hand is a transparent entity the relevant treaty provisions may be Art. 7 or Art. 11 of the OECD model. See to this effect *Lang: Hybride Finanzierungen im Internationalen Steuerrecht*, 1991, p. 136.

⁷⁵ See *Lang: Hybride Finanzierungen im Internationalen Steuerrecht*, 1991, p. 136.

⁷⁶ See in general regarding the interpretation of this Article, e.g. *Baker: Double Taxation Conventions*, 2003, pp. 10–1 et seq., *Vogel: On Double Taxation Conventions*, 1997, pp. 646 et seq., *Vogel/Löhner: DBA Doppelbesteuerungsabkommen Kommentar*, 2008, pp. 917 et seq., *Helminen: The Dividend Concept in International Tax Law*, 1999, passim, *Lang: Hybride Finanzierungen im Internationalen Steuerrecht*, 1991, pp. 85 et seq., *Schuch in Eigenkapital*, 2005, pp. 217 et seq., *Giuliani in Bulletin* 2002,

The OECD Commentaries are silent on the question of whether or not income from a share can be treated under Article 11. As analysed by *Pijl*, the question is whether a 'share' can ever leave the ambit of Article 10 and whether the dividend definition would exclude a share if the share is so thoroughly stripped that it does not participate in profits? *Pijl* here refers to preference shares that do not participate in profits and are materially equal to debt claims.⁷⁷ The author finds that Article 10(3) should be interpreted in a manner whereby the phrase 'participating in profits' also applies to shares. As a consequence being a share does not automatically mean that the yield of the share qualifies as dividends for tax treaty purposes.⁷⁸ The author concludes that 'participating in profits' refers back to the previously mentioned titles in the dividend article, which includes shares. Shares must participate in profits to make the income qualify under Article 10. A practical comment to this is that most preference shares seem to actually participate in the profits of the company since economic preference is the main feature of preference shares. However, *Pijl* finds that it would be jumping to conclusions if it is claimed that such income would not fall under Article 10, as the instrument could qualify as 'other corporate rights', subject to the same domestic tax treatment of the income. When the income from this type of preference shares is treated like a dividend in the state of the distributing company, a tax treaty accepts this under Article 10.⁷⁹ When domestic law does not treat the income from preference shares as participating in the profits of the company as dividends, such preference shares do not fall under the scope of Article 10, and the question arises whether Article 11 can be a substitute.⁸⁰ *Pijl* answers this question negatively as the term 'debt claim' in Article 11 should be taken in its legal meaning.⁸¹ As a consequence, even if a preference share has overwhelming debt claim characteristics, it cannot fall under Article 11. I agree with this interpretation.

This interpretation may not be in line with the interpretation of *Lang*, according to which mandatorily redeemable preferred stocks may be classified as debt for tax treaty purposes if the redemption price is fixed and does not depend on the income of the economic situation of the issuing company and the ongoing participation in profits include participation of the hidden reserves of the issuing company.⁸²

Generally, dividends from preference shares qualify as dividends according to Article 10 of the OECD Model.⁸³ Preference shares qualify as corporate rights for tax treaty purposes.⁸⁴ The scope of Article 10 includes dividends as well as liquidation proceeds which may arise from preference shares. This also includes non-voting cumulative preference shares and redeemable preferred stocks. The absence of voting rights seems to be of less relevance.⁸⁵ Investors with provisions on mandatory redemption share the risk of the company, but only until redemption. From a risk perspective the investment is therefore comparable to the risk of a debt investment.⁸⁶ In liquidation, the investment is similar to other share investments and not debt investments. According to *Helminen*, the only situation where a preferred share may not qualify as a corporate right is when it contains both a mandatory redemption provision that requires redemption within a relatively short period of time and a provision that grants liquidation preference.⁸⁷

Applying the debt claim test to preference shares this test should not be met since no debt claim exists.⁸⁸

Certain emissions of instruments in the Anglo-American market appear like preference shares but require a detailed analysis of the true content and nature of the instrument in question in order to determine whether the yield of such instrument should be considered dividends or interest payments. Yield from instruments which include the term preference share in the name should not necessarily be classified as dividends if the true economic

Notes

pp. 11 et seq., *Febér* in *Conflicts of Qualification in Tax Treaty Law*, Burgstaller/Haslinger (Eds.), 2007, pp. 227 et seq. (pp. 234 et seq.), *Avery Jones et al.* in *World Tax Journal* 2009, pp. 5 et seq.

⁷⁷ See *Pijl* in *BIT* 2011, pp. 493–494.

⁷⁸ See *Pijl* in *BIT* 2011, pp. 493–494.

⁷⁹ See *Pijl* in *BIT* 2011, pp. 493–494.

⁸⁰ See *Pijl* in *BIT* 2011, pp. 493–494.

⁸¹ See *Pijl* in *BIT* 2011, pp. 493–494.

⁸² *Lang*: *Hybride Finanzierungen im Internationalen Steuerrecht*, 1991, p. 138.

⁸³ See *Briesemeister*: *Hybride Finanzinstrumente im Ertragssteuerrecht*, 2006, p. 408, *Schuch* in Bertl et al. (eds.): *Eigenkapital*, 2004, pp. 230 et seq., *Hann*: *Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steuerrecht*, 1996, pp. 198 et seq.

⁸⁴ See *Vogel*, p. 653, stating that restriction of the control rights, as in the case of non-voting preference shares, therefore, do not result in disqualification for the purposes of Art. 10(3). Privileges and prejudices, even in respect of property rights, which lead to distinctions being made between various categories of shares, are likewise irrelevant, unless any lack of one of the essential elements of the term 'share' laid down in Art. 10(3) disqualifies a holder from claiming a share in the company's profits or a share in its liquidation proceeds.

⁸⁵ See *Briesemeister*: *Hybride Finanzinstrumente im Ertragssteuerrecht*, 2006, p. 408. See *Hann*: *Hybride Finanzierungsinstrumente im deutschen und US-amerikanischen Steuerrecht*, 1996, pp. 198 et seq. with respect to Adjustable Rate Preferred Stocks (ARPS).

⁸⁶ See *Helminen*: *The Dividend Concept in International tax Law*, 1999, p. 318.

⁸⁷ *Ibid.*, p. 318.

⁸⁸ See e.g. *Pijl* in *BIT* 2011, p. 494.

nature of the instrument would lead to a different classification.⁸⁹

Classification conflicts may arise if the state of residence treats the income from preferred shares as interest payments whereas the source state treats the same yield as dividends. The state of residence is not obliged to respect

the source state classification unless it agrees that the income originates from corporate rights.⁹⁰ In practice, classification conflicts are rare with respect to income from preferred shares.⁹¹ This conclusion is supported by the fact that only a few countries reclassify preference shares and the yield thereon for domestic tax purposes.

Notes

⁸⁹ See *Schuch* in Bertl et al. (eds.): *Eigenkapital*, 2004, p. 231.

⁹⁰ See *Helminen*: *The Dividend Concept in International tax Law*, 1999, p. 318.

⁹¹ See *Helminen*: *The Dividend Concept in International tax Law*, 1999, p. 319.

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