Convertible Debt Instruments in International Tax Law – Part 2

This two-part article contains an in-depth analysis of a variety of convertible debt instruments from the perspective of international tax law. Part 1, which was published in *European Taxation* 4 (2017), covered optional convertible instruments, mandatory and reverse convertibles, contingent convertibles, warrants and option loans and provided an overview of domestic law in a number of countries. Part 2 analyses the classification and treatment of the different types of convertible debt instruments from the perspective of EU corporate tax directives and tax treaties.

4. Domestic Tax Treatment of Mandatory Convertible Bonds and Reverse Convertibles

4.1. Comparative overview

Apparently, only a few countries have legislation that directly addresses mandatory convertibles and reverse convertibles. Moreover, case law on the classification of mandatory convertibles is scarce. Generally speaking, the tax treatment of mandatory convertibles and reverse convertibles is unclear in many countries.

Laukkanen (2007) provides an overview of country practices with regard to the tax treatment of reverse convertibles in Finland, Germany, the United Kingdom and the United States.[108] In the recent decision of the Swedish Supreme Administrative Court in Case No. 4745-13 (14 February 2014), it was decided that a mandatory convertible should be classified as equity and that the interest paid should be non-deductible.[109] The case involved an issuer of a convertible bond who, upon maturity, was entitled to repay the principal either in cash or through newly issued shares. According to international financial reporting standards (IFRS), the instrument was recognized as equity for accounting purposes. The Court initially stated that the instrument, at least according to its form, would fall under the definition of debt for tax purposes. The Court, however, found that the accounting treatment could also serve as a relevant starting point in determining the classification for tax purposes. The Court highlighted the fact that the instrument did not represent an obligation for the issuer to repay the principal out of its own funds, as it could choose to repay either in cash or by way of newly issued shares. This feature was considered as deviating from what would normally be considered debt for tax purposes. The Court ruled that the convertible bond should be considered as equity for tax purposes and thus that the interest expense on the bond should be non-deductible.

In the Indian *LMN* case (10 October 2008),[110] the Indian Authority for Advance Rulings (AAR) was presented with a "compulsory convertible bond (CCD)".[111] The AAR held that the payment made to the foreign company up to the date of conversion of CCDs into equity shares was to be treated as interest income in the hands of the foreign lender and would be taxed as such in India under both the provisions of the Indian Income Tax Act and article 11(2) of the India-United States Income Tax Treaty (1989).[112] According to the AAR, the income cannot be regarded as dividend income. In another more recent decision, the Delhi High Court held that proceeds from the sale of CCDs are taxable as interest income and not as capital gains (subject to capital gains tax) according to the India-Mauritius Income Tax Treaty (1982).[113]

In the Netherlands literature, a finding has been made that mandatory convertibles constitute equity from the moment they are issued.[114] This analysis does not, however, apply to reverse convertibles, which are considered debt until conversion.[115]

The tax treatment of reverse convertibles in the United Kingdom also seems fairly unclear.[116] Reverse convertibles are treated as interest generating instruments under German law. In Sweden, the instruments are treated as initially generating interest income, but capital gains upon

* Ph.D., Managing Director, CORIT Advisory LLP, Honorary Professor, Aarhus University. The author can be contacted at jb@corit.dk.

108. *See* A. Laukkanen, *Taxation of Investment Derivatives* p. 337 et seq. (IBFD 2007), Online Books IBFD.
109. *See* SE: SC, 14 Feb. 2014, Case No. 4745-13.
110. IN: AAR, 10 Oct. 2008, Case 2008-TIOL-18-ARA-IT, *LMN India Ltd*, Tax Treaty Case Law IBFD.
111. *See* S. Sanghvi, *Ruling on characterization of income from convertible debenture: a hybrid instrument*, 11 Derivs. & Fin. Instrums. 2, p. 74 (2009), Journals IBFD.
112. *Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (12 Dec. 1989), Treaties IBFD.
113. *Convention between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* (24 Aug. 1982), Treaties IBFD. *See* IN: High Court of Delhi, 30. July 2014, *Zaheer Mauritius v. DIT*, 47 taxmann.com 247 (Delhi) and for commentary P.R. Kumar Jhabakh, *Delhi High Court Ruling on Tax Treatment of Proceeds from the Sale of Compulsorily Convertible Debentures*, 16 Derivs. & Fin. Instrums. 5 (2014), Journals IBFD.
114. *See* R. Kok, *The Classification of Debt and Equity*, 16 Derivs. & Fin. Instrums. 4, p. 204 (2014), Journals IBFD.
115. Id.
116. *See* Laukkanen, *supra* n. 108, at 342.

conversion.[117] Netherlands law has been reported as classifying reverse convertible notes (RCN) as loans that produce interest. An integration approach applies to such loans, which, accordingly, are treated as one instrument.[118]

4.2. US federal tax law

Mandatory convertibles are classified under US law on a case-by-case basis according to the generally applicable debt/equity test. Accordingly, the tax treatment of mandatory convertibles depends on whether or not the specific mandatory convertible instrument has equity features. In an early Rev. Ruling, the IRS concluded that the mandatory convertible in question created a debtor-creditor relationship.[119] Later, the IRS issued guidance to the effect that instruments that, on balance, are more equity-like are unlikely to qualify as debt for federal tax purposes.[120] More recently, certain guidance from the IRS indicates that mandatory convertibles may not be treated as debt for tax purposes.[121]

In the United States, the classification of reverse convertibles is far from clear. This is based on the fact that contingency interests seem to be an equity feature. Accordingly, the practice in this area has not yet been established.[122]

4.3. German tax law

There is significant uncertainty regarding mandatory convertibles, in terms of the correct tax treatment, under German tax law as well.[123]

According to article 20(1), number 1 of the Income Tax Act and article 8(3), sentence 2 of the Corporate Income Tax Act,[124] HFIs are reclassified as equity if both remuneration payments are participations in the current profits of the capital borrower and the capital repayment is a participation in the liquidation proceeds of the capital borrower.

For German tax purposes, reverse convertibles are considered loan-producing instruments, with the payments received in the hands of the holder being treated as interest payments.[125] A loss upon redemption suffered by the RCN holder, where the issuers redeem the note at less than face value, is not relevant for German income tax purposes.

4.4. Danish tax law

Mandatory convertibles and reverse convertibles are not governed by any specific Danish tax provisions.[126] Consequently, such instruments are taxed in accordance with generally applicable tax rules. Unfortunately, it is impossible to conclude anything in general terms since the final outcome is dependent on the terms and conditions of the instrument in question. Quite often, mandatory and reverse convertibles contain several co-existing non-plain vanilla characteristics, which may lead to complications in the qualification process. Even with regard to mandatory convertibles, in their simplest form, there is significant uncertainty where no case law exists.

Such historical uncertainty was partially mitigated in 2005, pursuant to Act No. 1413 of 21 December 2005 (Bill No. L 78).[127] With this Act, the Danish Act on Taxation of Capital Gains on Sale of Shares (*Aktieavancebeskatningsloven*, ABL) was amended to include a specific provision regarding all convertible instruments. Accordingly, since 2005, the scope of the ABL has been broadened significantly regarding convertible instruments and, in the author's view, now includes mandatory convertibles and reverse convertibles within the scope of section 1(3). This question was not, however, clarified before a further legislative amendment was enacted.

By way of Act no. 530 of 17 June 2008 (Bill No. L 181), section 1(3) of the ABL was abolished. The Danish Ministry of Taxation seemingly concluded that the provision included mandatory and reverse convertibles. The background to the amendment apparently was that there was a risk that certain securities unintentionally were included within the scope of multiple tax laws with the possible effect that taxpayers could choose to apply whichever act was most beneficial.

It was stated in the preparatory remarks to the amendment repealing the specific provision, that other types of non-traditional convertible bonds are subject to taxation according to the Capital Gains Tax Act (*Kursgevinstloven*, KGL). This statement is problematic, since an instrument can only be included within the scope of the KGL if the instrument constitutes a claim/debt according to the applicable nomenclature. Therefore, the statement is far too general and does not fully reflect the complexity of HFIs. In the view of this author, the correct approach is to apply an interpretation pursuant to which each concrete mandatory and reverse convertible should be thor-

117. Id., at 347 and M. Dahlberg, *Ränta eller kapitalvinst – Grundproblem I kapitalinkomstbeskattningen – särskilt vad gäller finansiella instrument I gränslandet mellan lånekapital och eget capital*, p. 575 (Iustus 2011).
118. *See* H.M.M. Bierlaagh, *Tax Authorities State Position on Tax Treatment of Reverse Convertible Notes*, 39 Eur. Taxn. 8, p. 332 (1999), Journals IBFD and C. Rotondaro, *The Right to Redemption as a Key Characterization Factor in the OECD Model Convention Passive Income Taxation System – The Case of Reverse Convertibles*, 2 Derivs. & Fin. Instrums. 5, p. 259 (2000), Journals IBFD.
119. *See* Rev. Rul. 85-119 and A. Kramer, *Financial Products: Taxation, Regulation and Design*, Vol. 3., sec. 49.05 (CCH looseleaf), for a detailed analysis of administrative practice.
120. *See* Notice 94-47.
121. *See* Kramer, *supra* n. 119.
122. *See* M.J. Feder, *Tax Treatment of Debt Instruments Without Fixed Right to Redemption*, 3 Derivs. & Fin. Instrums. 4, p. 245 (2001), Journals IBFD.
123. *See* S. Briesemeister, *Hybride Finanzinstrumente im Ertragsteuerrecht* p. 263 et seq. (IDW 2006) and H. Häuselmann & S. Wagner, *Steuerbilanzielle Erfassung aktienbezogener Anleihen: Options-, Wandel-, Umtausch- und Aktieanleihen*, BB 47, pp. 2431-2436 (2002) and H. Häuselmann, *Die Steuerliche Erfassung von Pflichtwandelanleihen*, BB 30, p. 1531 et seq. (2003).
124. DE: Income Tax Act (*Einkommensteuergesetz*, EStG), National Legislation IBFD and DE: Corporate Income Tax Act (*Körperschaftsteuergesetz*, KStG), National Legislation IBFD.
125. *See* Rotondaro, *supra* n. 118, at 259, with further references.
126. *See*, for a more detailed analysis in Danish, J. Bundgaard, *Finansiel Innovation som skatteretlig udfordring – Mandatory Convertibles & Reverse Convertibles i dansk skatteret*, in *Festskrift til Jan Pedersen*, p. 35 et seq. (M. Kerzel ed., Djøf Forlag 2011), accessible at https://www.djoef-forlag.dk/da/boeger/f/festskrift-til-jan-pedersen.
127. DK: Act No. 1413, 21 Dec. 2005, Bill No. L 78.

oughly analysed in light of the different alternatives available under existing legislation.[128]

As such, it can be concluded that the Danish domestic tax treatment of mandatory and reverse convertibles is characterized by a high degree of uncertainty. This uncertainty is even more pronounced in the international context.

5. Contingent Convertibles

5.1. Comparative overview

CoCos, as a form of additional Tier 1 capital, were analysed, from a tax law perspective, in the Comparative Survey in *Derivatives and Financial Instruments* 3 (2011).[129] The relevant tax questions examined included: the treatment of bonds prior to conversion as debt or equity; the criteria for characterization as equity; where treated as debt, the deductibility of interest paid on bonds for corporate tax purposes; and the withholding tax imposed on any interest paid. Further, it examined the treatment of interest deferral, the influence of an alternative coupon settlement, as well as the tax consequences upon conversion.[130]

CoCos are still a novelty in the financial markets and, as such, there is no uniform treatment and classification. The United Kingdom would most likely classify CoCos as convertible securities and apply a bifurcation approach, whereby the product would be split into a loan and an embedded option (where the option can be exercised only in respect of a fixed number of shares and for a fixed amount of cash) or an embedded derivative (where it is not treated as an equity instrument).[131] Following the entry into force of the Taxation of Regulatory Capital Securities Regulations 2013 on 1 January 2014, however, this uncertainty might have been abolished.[132] According to the new regulations, Tier 1 and Tier 2 instruments are now taxed in the United Kingdom as loans (i.e. deductible coupons with no withholding tax applicable) and a write-down or conversion will not trigger any taxation for the issuer or the holder.[133] In Canada, there appears to be a sound basis for the deductibility of interest paid on CoCos by the issuer.[134] In the Netherlands, it seems that uncertainty prevails and the relevant test is whether or not the debt effectively functions as equity.[135] CoCos are not known to the French market, but should be treated as debt for tax purposes.[136] The classification of CoCos under Italian law is also highly uncertain.[137] Under Swiss law, CoCos will usually be treated as debt for tax purposes based on how they are recorded in the company's accounting records.

5.2. Federal US tax law

CoCos are described in the tax literature as bonds that cannot be converted by the holder unless a price in excess of the normal conversion price is paid.[138] Thus, for example, a convertible bond with a CoCo feature that has a conversion premium of 20% might be convertible only if the price is equal to 120% of the conversion price.

The US IRS has issued a public ruling (Rev. Rul. 2002-31) that describes the conditions under which a CoCo debt instrument may be treated as debt for US tax purposes.[139] According to US commentary, CoCos are not sufficiently similar to the instrument considered in Rev. Ruling 2002-31 to be able to conclusively rely upon the ruling for a debt characterization. Thus, the CoCo must be tested under the general rules for distinguishing debt from equity under US tax law. US commentators have concluded that:[140]

> On balance, a few of the factors that the IRS and courts have used to determine whether an instrument is debt or equity support the view that the CoCos here are debt, but other factors support the view that the CoCos are equity. In particular, the conversion feature and the lack of an unconditional promise to pay a sum certain, the subordinated status of the instruments, and the lack of creditor rights upon conversion all weigh in favor of equity treatment. Further, if the term of the CoCos is perpetual, then that factor, combined with the others, would strongly weigh in favor of equity treatment. Assuming that the term is fixed in the range of 30 to 50 years, however, the ultimate conclusion the IRS or a court reaches will probably rest on the likelihood that the conversion will be triggered. This is because a CoCo's novel feature is that it has a mandatory conversion feature that, unlike conventional convertible debt, which is generally respected as debt for U.S. federal income tax purposes, does not guarantee

128. In a later decision in DK: TfS 2009.67 SR, further light was shed on the topic and the decision gives hope that concrete assessments will apply in future cases. The hope is based on statements made by the Tax Board to the effect that a concrete assessment can lead to a classification of mandatory bonds as warrants, convertible bonds, or a claim for tax purposes. Although the statement was not decisive in the actual case, this seems to be a much more balanced and correct approach. Moreover, the Danish Tax Board found that the convertible instrument in question should be treated as a single instrument (integration approach).
129. The key features are described in *Introduction to the Comparative Survey*, 13 Derivs. & Fin. Instrums. 3, p. 96 (2011), Journals IBFD.
130. The survey includes country practices in the United States (V. Hammer, S. Chen & P. Carman, *Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 97 et seq. (2011), Journals IBFD); the United Kingdom (D. Stuttaford & A. James, *Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 107 (2011), Journals IBFD); Canada (B.R. Sinclair, *Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 108 et seq. (2011), Journals IBFD); the Netherlands (W.H.A. Specken, *Tax Treatment of the Issuer and Bond Holders of Contingent Convertibles*, 13 Derivs. & Fin. Instrums. 3, p. 112 et seq. (2011), Journals IBFD); Germany (M. Krause, *Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 113 et seq. (2011), Journals IBFD); France (G. Jolly, *Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 115 et seq. (2011), Journals IBFD); Italy (M. Ragusa, *Tax Treatment of the Issuer and Contingent Convertible Bond Holders*, 13 Derivs. & Fin. Instrums. 3, p. 118 et seq. (2011), Journals IBFD); Switzerland (D. Schmucki-Fricker & M. Kronauer, *Tax Treatment of the Resident Issuer and Resident Contingent Convertible Bond Holders*, 13 Derivs. & Fin. Instrums. 3, p. 120 et seq. (2011), Journals IBFD); and Luxembourg (F. van Kuijk, *Corporate Income Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 122 et seq. (2011), Journals IBFD).
131. *See* Stuttaford & James, *supra* n. 130. The authors state that the treatment is likely to change as a result of IFRS 9.
132. *See* Green et al., *Hybrid Securities: An Overview*, PLC, Capital Markets Multi-Jurisdictional Guide 2015/16, p. 9.
133. Id.
134. *See* Sinclair, *supra* n. 130.
135. *See* Specken, *supra* n. 130, at 112.
136. *See* Jolly, *supra* n. 130, at 115.
137. *See* Ragusa, *supra* n. 130, at 118.
138. *See* D. Trier et al., *The Taxation of Convertibles after Revenue Ruling 2002*, Tax Forum No. 734 Practicing Law Institute/Tax p. 3 et seq.
139. *See* Hammer, Chen & Carman, *supra* n. 130, at 97, Hammer & Chen, *Tax Implications of Contingent Convertible Securities. Host Country Response: United States (draft)*, Tax Management International Forum Spring 2012 and Kramer, *supra* n. 119, at sec. 49.08.
140. *See* Hammer, Chen & Carman, *supra* n. 130, at 102 and Hammer & Chen, *supra* n. 130.

> that the conversion will give the holder stock having a value equal to or greater than the principal amount of the CoCo. This mandatory conversion feature, depending on the likelihood that it will be triggered, results in the lack of an unconditional promise to pay a sum certain, which is perhaps the most important factor supporting the classification of an instrument as debt [...].

Finally:

> Absent a ruling from the IRS, the treatment of CoCos cannot be determined with certainty, and equity treatment for tax purposes may become the opinion standard followed by most issuers. However, given the proclivity of the tax authorities to be supportive of the debt treatment of hybrid type instruments approved by banking authorities, the U.S. tax authorities could conclude that debt treatment is proper [...].

Other commentators have concluded[141] that there might be a need for Congressional or US Treasury Department action before a US issuer can be reasonably sure that distributions on a contingent capital instrument are deductible for US federal income tax purposes.

5.3. German tax law

Under German law, the classification of CoCos depends on whether the issuer is a partnership or a corporation.[142] If the issuer is a partnership, a CoCo should qualify as debt, from a civil law perspective, provided it is structured in a debt format.[143] Prior to conversion, the CoCo does not entitle the holder to any rights that a partner has.[144] With regard to corporations, the situation is less clear under German law. If CoCos satisfy the GAAP criteria for equity treatment, they qualify as equity.[145] There is no obvious result, however, since equity classification is supported by the perpetuity and contingency of coupons, as well as the exclusion of insolvency, whereas debt classification is supported by the debt format.[146] Krause (2011) found that the intended burden on the issuer is to pay fixed income rather than a share of the profits and losses. No unique view has been formed in the industry in Germany regarding the classification of CoCos issued by corporate entities. In light of the fine line between equity and debt, even a minimal modification of the term sheet or a minimal ramification might result in a change of classification.[147]

5.4. Danish tax law

CoCo bonds have not been dealt with under Danish legislation or case law. Accordingly, the classification of such instruments should be made in accordance with the traditional principles of tax classification. Consequently, the classification depends on the debt-equity features of the actual instruments. Generally speaking, in the opinion of this author, the most likely classification of CoCos follows that of mandatory and reverse convertibles. In the recent decision of the Danish Tax Board in SKM2014.711.SR,[148] the Court had an opportunity to deal with CoCos for the first time. The Tax Board was asked to confirm that a specific type of security with a contingent feature would be classified as a claim for the potential investors, which was subject to taxation according to the KGL. The security in question was issued at par value with a stated interest. Moreover, the creditor could not demand conversion. Repayment would occur at a certain date if conversion had not taken place prior to this date. The Tax Board did not consider the security to be a convertible bond for Danish tax purposes since the creditor could not demand conversion. Moreover, the Tax Board did not consider the security to be a structured bond according to article 29(3) of the KGL. Instead, the Tax Board found that the security should be classified as a traditional claim subject to taxation according to the KGL. The Tax Board did not consider it to be of any significance that the claim could potentially be repaid in shares rather than in cash.

6. Warrant Loans

6.1. Comparative overview

In countries following a bifurcation approach, warrant loans seem to be treated according to the tax rules governing the underlying instrument, i.e. bond or warrant/option. Under Swedish law, for example, such instruments are known as *teckningsoptioner med skuldbrev* or *optionslån*, which have been directly governed by Swedish company law since 1975.[149] Under Swedish law, warrant loans are treated partly as warrants (*teckningsoption*) and partly as bonds (*skuldbrev*) for tax purposes and the purchase price is determined according to both the *restvärdemetod* and the *C-metoden*, according to which the value of the bond is set at fair market value with any remaining value being allocated to the warrant.[150]

6.2. US federal tax law

Warrant loans are commonly known in the United States.[151] Frequently, issuers in the US market raise capital through the issuance of an investment unit, which typically consists of a debt instrument plus a warrant to acquire the issuer's stock.[152] Investment units are defined in section 1273(c) of the IRC as a debt instrument and an option, security, or other property right. At least in terms of the US Original Issue Discount (OID) rules, warrants are treated as a separate property right. It is, therefore, necessary to allocate the overall purchase price between the two assets acquired.[153] Such an allocation is generally based on fair market value and the value of the warrants is based on their value at the time of issuance rather than exercise.[154] When a warrant is exercised, no gain or loss is recognized in the hands of the holder of the warrant. The amount paid for the warrant simply becomes part of the

141. *See* Green et al., *supra* n. 132, at 9.
142. *See* Krause, *supra* n. 130, at 113.
143. Id.
144. Id.
145. Id.
146. Id.
147. Id., at 114.
148. DK: Tax Board, SKM2014.711.SR.
149. Dahlberg, *supra* n. 117, at 533.
150. Dahlberg, *supra* n. 117, at 541 et seq.
151. D. Garlock, *Federal Income Taxation of Debt Instruments*, sec. 1001.01 et seq. (Prentice Hall & Business 2007) describes these types of instruments as debt issued together with property rights, where warrants and options are subdivisions of this overall category.
152. Id., at 10,002 et seq.
153. Id.
154. Id.

cost base of the stock acquired in respect of the warrant. Moreover, the issuer does not receive an interest deduction or recognize a loss equal to the excess of the value of the stock over the sum of the amount received for the warrant and the amount received upon its exercise.[155]

6.3. German tax law

Warrant loans and option loans (*optionsanleihen*) are commonly used in the German market and their treatment is, in general, similar to convertible bonds.[156] The tax treatment of the issuer of a warrant bond in Germany is identical to that of the issuance of a convertible bond.[157]

With regard to a corporate holder, the taxation of profits deriving from a warrant bond follows the accounting treatment. This means that the bond and warrant are treated as independent assets for tax purposes, i.e. a bifurcation approach is applied. As a result, warrant and option loans are taxed based on their specific components, i.e. the bond and warrant/option components.[158] In specific circumstances, the owner of *optionsanleihen* can be regarded as a participant in a capital company.[159]

As a consequence of this classification, the warrant bond produces interest income, which is taxable for the holder and deductible for the issuer.[160] Income and expenses have to be allocated over the lifetime of the bonds. The issuance of warrant loans and convertible bonds does not result in a realization of (taxable) capital gains or losses either at the level of the creditor or the German resident debtor company.[161] Convertible bonds and option loans may be classified as equity if they also include other equity characteristics.[162]

6.4. Danish tax law[163]

Warrant and options loans are not commonly used in Danish law. Despite their similarity to convertible bonds, the case law and commentary is very limited.

In SKM2006.60.LSR,[164] the Danish Tax Tribunal indirectly took a position on warrant loans as part of an incentive scheme for employees in the issuing company. More precisely, the issue at hand was establishing the timing of acquisition, which was found to be upon the granting of the instruments to the employees. The Danish Tax Tribunal made a remark of general importance. It stated that the granting of warrants in connection with the issuance of a bond loan should be treated as a separate arrangement. In this regard, the Tax Tribunal emphasized that the two distinct financial instruments did not have an identical term and that the warrants could not be seen as being directly part of the issuance of the loan.

The leading case in Denmark is the Supreme Court decision in SKM2012.2.H DSV A/S (22 December 2011). A leading Danish listed company obtained external financing for the acquisition of another foreign company in 2000. The financing was obtained through the issuance of shares, plain vanilla bank loans and mezzanine capital. Warrants were issued to one of the creditors as part of the conditions of the overall financing package. The warrants were transferrable to third parties and no specific payment was agreed for the warrants. The warrants were to be exercised no later than 30 months following repayment in full of the loan. Moreover, the issuer was to pay a "back-end" fee per share for a drop in the listed share price. All warrants were exercised in 2004 and 2005 at a favourable value. The costs in this regard, including the "back-end" fee, were computed as the difference between the listed price for the shares and the exercise price. The costs were treated as deductible costs by the company. The Danish tax authorities did not, however, recognize the deduction. The Supreme Court made the argument clear, stating that the case was basically about the deductibility of costs according to the KGL as a loss suffered in the context of loan repayment or as costs in obtaining the loan.

The Supreme Court did not consider the costs to be losses in relation to the cost of obtaining a loan as specifically defined in article 26(3) of the KGL and the preparatory work to this provision. Moreover, the Supreme Court stated that the KGL does not address the tax treatment of warrants. Warrants are covered by the ABL with regard to the investor. It was stated that the loan and the warrants should be seen as two separate agreements, with the tax treatment being addressed by different sets of rules. The two agreements were considered to be connected in the sense that the issuance of the loan was closely connected to the granting of the warrants. The Supreme Court stated that the value of the loan was not affected by the warrants. Consequently, the Court found that the loss in respect of the loan falling within the scope of the KGL should not be considered a capital loss. The same result applied with regard to the "back-end" fee, which was treated as being a component of the warrants. This decision has provided clarification on certain issues regarding the Danish tax treatment of warrant loans.

7. Treatment According to EU Corporate Tax Directives

7.1. Optional convertibles

The Interest and Royalties Directive (2003/49)[165] is more informative than the Parent-Subsidiary Directive

155. Id., at 10,004.
156. *See* M. Theisen & M. Wenz, *Tax Treatment of Financial Instruments*, p. 185 et seq. (Michielse ed., Kluwer 1996); Laukkanen, *supra* n. 108, at 328; Briesemeister, *supra* n. 123, at 254 et seq. and J. Haun, *Hybride Finanzierungsinstrumente im Deutschen und US-amerikanischen Steuerrecht*, p. 203 (Peter Lang 1996).
157. *See* S. Trapp, *Taxation of Hybrid Instruments: Germany*, 13 Derivs. & Fin. Instrums. 6, p. 325 et seq. (1999), Journals IBFD.
158. *See* Briesemeister, *supra* n. 123, at 257.
159. Id., at 262.
160. *See* Theisen and Wenz, *supra* n. 156, at 189 and M. Helminen, *The Dividend Concept in International Tax Law – Dividend Payments Between Corporate Entities*, vol. 25 (Kluwer Law International 1999).
161. Theisen and Wenz, *supra* n. 157, at 187.
162. Helminen, *supra* n. 160, at 299.
163. *See*, for a thorough analysis regarding Danish law, J. Bundgaard, *Warrantlån og optionslån i dansk og international skatteret*, TfS 2012.118.
164. DK: Tax Tribunal, SKM2006.60.LSR.
165. Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between

(2011/96)[166] in terms of defining which payments are included within the scope of the Directive. The notion of interest is defined directly in article 2(1)(a) of the Interest and Royalties Directive as follows:

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

As the wording refers to debt claims of any kind, any debt claim that is a debt claim for private law purposes falls within the scope of the Interest and Royalties Directive (2003/49). At first glance, the notion of interest in this Directive is particularly wide, also including yield from certain HFIs.[167] Article 2, however, should be read in conjunction with article 4 of the Directive in order to assess the actual scope of the interest definition.[168] In article 4 of the Directive, the source state is granted the right not to grant the benefits of the Directive in circumstances in which some common types of HFIs are used.

The third exclusion from the notion of interest is interest payments from debt claims that entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits (article 4(1)(c)).

The wording of this provision is ambiguous. According to Distaso and Russo (2004), a literal interpretation of the wording in the Directive seems to clearly include interest-bearing loans that provide the possibility for the creditor to convert his entitlement to the interest into a right to a percentage of the profits of the borrower.[169] The reference to a "right to participate in the debtor's profits" rather than to the "debtor's equity" does not, however, clearly and automatically include financial instruments granting the right to convert the loan (and, in certain cases, the interest income accrued) into share capital of the borrower (i.e. traditional convertible loans/bonds). The question is whether the reference to a right to interest is simply another term for the claim in general and the reference to the right to participate in the debtor's profits simply is another way of describing a participation in the debtor's equity. It has been argued, on the basis of a literal interpretation of the provision, that this excludes convertible bonds and warrant bonds from the scope of the Interest and Royalties Directive (2003/49).[170]

Accordingly, such instruments and the yield thereon may fall outside the scope of the Directive. The enumeration of excluded financial instruments should be considered as being exhaustive, in contrast to previous drafts of the Directive.[171] An *e contrario* interpretation should lead to the conclusion that, in the absence of this specific provision in article 4(1)(d), such instruments would fall within the scope of the interest definition.

If the Member States in question do not exercise the right to exclude convertible debt instruments from the benefits of the Directive, 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 article 2.

The effect of article 4(1)(a) on national thin cap provisions that do not result in a reclassification is still uncertain.[172] In line with the analysis presented herein, it is commonly agreed in commentaries that where such payments are treated as distributions of profit in the source state, they should fall within the scope of the Parent-Subsidiary Directive (2011/96) instead.[173] This was also explicitly stated in COM(1998) 67 final[174] regarding the previous draft of the Directive. A similar result does not automatically apply with regard to the interest payments mentioned in article 4(b)-(d). If such payments (including interest payments on convertibles) are in fact reclassified as "distributed profits", the same interpretation ought to apply to such payments. Accordingly, the Parent-Subsidiary Directive arguably takes precedence over the Interest and Royalties Directive (2003/49).[175] It has been argued in the tax literature that the Parent-Subsidiary Directive includes income from hybrid debt, which, by its nature, is actually equity and, therefore, taxed as a dividend in the Member States.[176] Based on this, it has, moreover, been argued that the Parent-Subsidiary Directive is applicable to income from convertible debt if Member States choose to tax interest on convertible debt as dividends.[177] Finally, it has been argued that the Parent-Subsidiary Directive is applicable to convertible 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.[178]

Payments on convertible debt instruments falling outside the scope of the Interest and Royalties Directive (2003/49)

Companies of Different Member States, OJ L157 (2003), EU Law IBFD.

166. Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, OJ L 345/8 (2011), EU Law IBFD.
167. *See* M. Distaso & R. Russo, *The EC Interest and Royalties Directive – A Comment*, 44 Eur. Taxn. 4, p. 149 (2004), Journals IBFD.
168. Id.
169. Id., at 150.
170. *See* E. Eberhartinger & M. Six, *National Tax Policy, The Directives and Hybrid Finance* p. 24 (Springer 2007), and Distaso & Russo, *supra* n. 167, at 150.
171. *See* D. Weber, *The Proposed EC Interest and Royalty Directive*, 9 EC Tax Rev. 1, p. 25 (2000).
172. *See* M. Gusmeroli, *Triangular cases and the Interest and Royalties Directive: Untying the Gordian Knot? – Part 2*, 45 Eur. Taxn. 2, p. 44 (2005), Journals IBFD.
173. *See* Eberhartinger & Six, *supra* n. 170, at 23 and Distaso & Russo, *supra* n. 167, at 150.
174. Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States, COM(1998) 67 final (4 Mar. 1998), EU Law IBFD.
175. Eberhartinger & Six, *supra* n. 170, moreover 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 (2011/96), if the source state does not execute the option in art. 4(1)(a) of the Interest and Royalties Directive (2003/49) and if these payments fall under the scope of both directives.
176. Helminen, *supra* n. 160, at 193.
177. Id.
178. Id.

do not automatically fall within the scope of the Parent-Subsidiary Directive (2011/96). Accordingly, there is no guarantee that payments on convertible debt instruments that have been denied the benefits of the Interest and Royalties Directive will be granted the benefits of the Parent-Subsidiary Directive instead.

7.2. Mandatory convertibles

Mandatory convertibles and reverse convertibles have not been addressed directly in any existing EU sources of tax law. The prevailing interpretation leaves convertible instruments outside the scope of the Interest and Royalties Directive (2003/49), and this might also apply to mandatory and reverse convertibles. This question remains uncertain. Accordingly, such instruments and the yield thereon may fall outside the scope of the Directive.

If the Member States in question do not exercise the right to exclude convertible debt instruments from the benefits of the Directive, 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 article 2.

Payments on mandatory and reverse convertible instruments falling outside the scope of the Interest and Royalties Directive (2003/49) do not automatically fall within the scope of the Parent-Subsidiary Directive (2011/96). Accordingly, there is no guarantee that payments on convertible debt instruments that have been denied the benefits of the Interest and Royalties Directive will be granted benefits under the Parent-Subsidiary Directive instead.

7.3. Contingent convertibles

Due to the fact that optional, mandatory, reverse and CoCo instruments share the common feature of convertibility, the analysis in terms of the applicability of EU company tax directives is considered identical. Accordingly, reference is made to the above analysis.

7.4. Warrant loans

Warrant loans are not typically treated as equity. Should this occur, it raises the question of whether withholding tax is triggered and whether the Parent-Subsidiary Directive (2011/96) applies. This question has not yet been clarified, but an application of the Directive would require that the source state classify the yield as a dividend and that the ECJ apply a teleological interpretation.[179]

A bifurcation approach is likely to apply pursuant to which the debt element of the warrant loan should be governed by the Interest and Royalties Directive (2003/49).

The treatment of the yield on warrant loans seems to be identical to the treatment of the yield on convertible bonds. Accordingly, reference is made to section 7.1. on the treatment of yield on convertible bonds under the EU company tax directives.

8. Treatment According to Tax Treaties

8.1. Optional convertibles

In general, the remuneration on HFIs may be classified as business income under article 7, a dividend payment under article 10, an interest payment under article 11, capital gains under article 13 or as other income under article 21 of tax treaties based on the OECD Model. For the sake of simplicity, only the dividend provision and the interest provision are analysed in this section with regard to convertible debt instruments. The demarcation is of great significance since the taxing right under the treaties differs depending on the type of income.

Convertible bonds and the tax treaty treatment of such instruments are not directly mentioned in the OECD Model. With regard to convertible bonds, it is explicitly stated in paragraph 24 of the Commentary on Article 10 of the OECD Model (2014)[180] that interest on convertible debentures is not a dividend. Moreover, it is stated in paragraph 19 of the Commentary on Article 11 of the OECD Model (2014), that interest on convertible bonds should not be considered a dividend until such time as the bonds are actually converted into shares. A reservation is made in paragraph 19, however, to the effect that such interest should be considered a dividend if the loan effectively shares the risks assumed by the debtor company.

Based on this, it is generally assumed that interest on convertible instruments qualifies as interest according to the OECD Model because a convertible loan is not a corporate right.[181] A conversion right does not constitute a corporate right.

The above also indicates that this dividend classification might arise in respect of certain convertible instruments. The type of convertible instrument that could, in fact, take enough of a part in the entrepreneurial risks of the issuing company to be considered a dividend generating right, remains unclear. It appears that dividend treatment will only be ascribed if other equity characteristics are integrated into the convertible bond since the conversion rights do not, on a standalone basis, lead to a dividend classification. Helminen (2010) states that a convertible loan qualifies as a dividend generating corporate right only after the actual conversion or if the investor, in addition to possessing the conversion right, also participates in the profits, liquidation proceeds and losses of the corporation.[182]

179. J. Bundgaard, *Classification and Treatment of Hybrid Financial Instruments and Income Derived Therefrom under EU Corporate Tax Directives – Part 1*, 50 Eur. Taxn. 10, p. 490 et seq. (2010), Journals IBFD.

180. *OECD Model Tax Convention on Income and on Capital: Commentary on Article 10* para. 24 (26 July 2014), Models IBFD.

181. *See* Helminen, *supra* n. 160, at 193, M. Lang, *Hybride Finanzierungen im Internationalen Steuerrecht– Rechtsgrundlagen der Doppelbesteuerungsabkommen zur Beurteilung von Mischformen Zwischen Eigen- und Fremdkapital*, p. 145 (Orac 1991), T. Fehér in *Conflicts of Qualification in Tax Treaty Law* p. 247 (E. Burgstaller & K. Haslinger eds., Taxmann 2007); J. Schuch in *Eigenkapital* p. 231 (R. Bertl et al. eds., Linde Verlag 2004) and W. Haslehner in *Klaus Vogel on Double Taxation Conventions*, p. 842, mn. 106 (E. Reimer & A. Rust eds., Kluwer Law International 2015).

182. *See* Helminen, *supra* n. 160.

Another question is the tax treatment of income realized upon a conversion from debt into equity. Basically, the claim no longer exists after conversion. Accordingly, the question is whether the income can even be considered interest income under the applicable tax treaty.[183] The solution seems to be found in the Commentary on Article 13 of the OECD Model, paragraph 31 of which states that:[184]

The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to limited tax in the State of source of the interest in accordance with Article 11 [...].

8.2. Mandatory convertibles

The OECD Model and its Commentaries do not deal with the classification of mandatory convertibles or reverse convertibles. If the conversion of a debt instrument is mandatory, the conversion right/obligation might constitute the kind of risk required of dividend generating corporate rights.[185] Schuch (2004) takes the claim and interest payment further by stating that mandatory convertibles and reverse convertibles do not fall under the scope of Article 10 of the OECD Model.[186]

Fehér (2007), points to the form-based approach of article 11, wherein debt claims of every kind shine through the entire definition of interest.[187] The author, moreover, points out the difficulties in treating mandatory convertible bonds as instruments producing interest. Fehér states the following:[188]

> The holder does not seem to have a real claim in respect of its contribution. Of course, this would depend on the details of the arrangement (guarantees, etc.), but if a drop in the share price were to lead to a drop in the redeemable amount of the contribution, then we would hardly speak of a genuine claim in respect of the principal, and thus the yield would not qualify as interest for treaty purposes [...].

In a comprehensive analysis of the classification of reverse convertibles, Rotondaro (2000) has analysed the notion of "interest" as applied in article 11(3) of the OECD Model.[189] He argues that the existence of an absolute and unconditional right to redemption is to be regarded as the basic feature of debt claims giving rise to interest under article 11 of the OECD Model.[190] The author states that, despite the fact that uncertainty exists in respect of an instrument regarding its yield, this does not exclude interest classification under tax treaties; the opposite conclusion is to be made regarding uncertainty concerning redemption of the principal.[191] Based on this view, there can only be interest under article 11 when the lender has a certain and unconditional right to repayment of the face value of the credit. With regard to reverse convertibles, the author concludes that proceeds from such instruments cannot be regarded as interest for the purpose of the OECD Model and treaties based on the OECD Model.[192] Instead, it would be more suitable to allow reverse convertible yields to fall within the scope of application of article 13 regarding capital gains, as the requirements under this provision appear to be looser and less demanding.

Based on the above, no firm conclusion can be made with regard to the tax treaty classification of mandatory convertible debt instruments.

8.3. Contingent convertibles

Due to the common feature of convertibility between optional, mandatory, reverse and CoCo instruments, the analysis in terms of the applicability of tax treaties seems parallel among these types of instruments. Accordingly, reference is made to sections 2.9.1. and 2.9.2. As such, no firm conclusion can be made with regard to the tax treaty classification of CoCos.

8.4. Warrant loans

For tax treaty purposes, emphasis should be placed on the fact that warrant loans and option loans contain a claim apart from the warrant or option, which is also contained in the instrument.[193]

In instances where the warrant can be separated from the loan or possibly traded separately, it should constitute a separate asset. If the warrant is not exercised, but is instead transferred, this should be viewed as a transfer of property in the sense of article 13 of the OECD Model, unless the warrant can be allocated to a permanent establishment according to article 7(1) of the OECD Model. The exercise of the warrants results in shares, which are considered "corporate rights" in accordance with article 10 of the OECD Model. Any further income from the shares should consequently be considered dividends for tax treaty purposes.[194]

9. Conclusions

The use of convertible instruments is widespread in the financial industry, as well as in the corporate sector both in terms of venture capital and in private transactions. There are a variety of convertible instruments. This article has analysed optional convertible bonds, mandatory convertible bonds, reverse convertibles, CoCos and warrant loans.

The tax law consequences of such instruments are an important factor in this respect. This article has introduced the economic, legal and

183. *See* Lang, *supra* n. 181, at 146 and Schuch, *supra* n. 181 at 232.
184. *See also* para. 20 *OECD Model: Commentary on Article 11* (2014).
185. *See* Helminen, *supra* n. 160.
186. Schuch, *supra* n. 181, at 231.
187. Fehér, *supra* n. 181, at 248.
188. Id., at 248.
189. *See* Rotondaro, *supra* n. 118, at 258 et seq.
190. Id., at 264.
191. Id., at 265.
192. Id., at 268.
193. *See* Lang, *supra* n. 181, at 147 and, in support of this view, Schuch, *supra* n. 181 at 232.
194. Lang, id., at 147.

rating framework regarding these instruments, while explaining the financial rationale of issuing and investing in convertible instruments. It is beyond doubt that convertible instruments serve financial objectives. Accordingly, it is important that tax legislation in the jurisdictions involved does not impede the use of such instruments. This analysis has shown that domestic law governing the instruments can vary, which, in cross-border transactions, may lead to legal uncertainty.

Most countries classify optional convertibles as debt for tax law purposes. This includes Denmark, Germany and the United States. The picture is somewhat more scattered with regard to mandatory convertibles and reverse convertibles. Accordingly, the US, German and Danish classification of such instruments is far from clear. Similarly, the classification of CoCos is not certain in the United States. Turning to warrant loans, such instruments are typically treated as two separate instruments for US federal tax purposes. In the German context, warrant loans are treated as optional convertible bonds for the issuer. From the perspective of the holder, the instrument is bifurcated into the two components (a warrant and a loan). Under Danish law, the Supreme Court has accepted a bifurcation approach from the perspective of the issuer, resulting in the disallowance of the financing costs associated with the issuance of warrant loans.

Under the Interest and Royalties Directive (2003/49), it is up to the Member States to decide whether or not the benefits of the Directive should apply to remuneration on optional and mandatory convertible instruments. A similar approach seems to be applicable in respect of CoCos and warrant loans. The analysis herein has shown that such payments are not automatically subject to the benefits of the Parent-Subsidiary Directive (2011/96) unless the payment is in fact reclassified as a dividend. From the perspective of tax treaties, it can be concluded that, in general, remuneration on convertible instruments is not classified as dividends.

With regard to tax treaty classification, on the one hand, it is generally assumed that interest on convertible bonds qualifies as interest according to article 11 of the OECD Model. On the other hand, no firm conclusion can be made on the basis of the above analysis with regard to the tax treaty classification of mandatory convertibles, reverse convertibles, CoCos and warrant loans.

