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Convertible Debt Instruments in International Tax Law – Part 1

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 covers optional convertible instruments, mandatory and reverse convertibles, contingent convertibles, warrants and option loans and provides an overview of domestic law in a number of countries. Part 2, to be published in *European Taxation* 5 (2017), analyses the classification and treatment of the different types of convertible debt instruments from the perspective of EU corporate tax directives and tax treaties.

1. Introduction

Convertible bonds are a well-known form of hybrid financial instrument (HFI) and an important alternative to traditional financial instruments.[1] The first issuance of convertible bonds dates back to 1881 when J.J. Hill, a US railroad pioneer, designed an innovative long-term financing instrument that did not involve selling shares. This was necessary since he found that the market would price the risk of his ventures too high.[2] The use of convertible bonds has increased significantly since then[3] and a variety of such instruments is now available.[4]

Convertible bonds are considered HFIs, as they contain characteristics of debt, as well as equity.[5] This may give rise to challenges from a tax law perspective and even more so in an international context, as the countries involved might classify and treat the instrument at hand differently. Consequently, double taxation might arise, but possibilities for tax arbitrage still exist.

2. Financial and Contractual Structure

2.1. Optional convertible bonds: Financial and contractual structure

The notion of a convertible bond is a financial term arising in the financial markets.[6] Commonly, convertible bonds, convertible debentures and convertible loan stock are described as "unsecured fixed-interest bonds", giving the owner a right, but not an obligation, to convert the convertible bond into equity of the issuing company upon the fulfilment of certain specified terms and conditions.[7] From a financial perspective, convertible bonds can be seen as a combination of a common bond and a call option (or a warrant).[8] The call option on the yield of the issuing company is described as "an integral part of equity ownership".[9] Alternatively, convertible bonds are described as containing "equity kickers".[10] If conversion does not occur, full repayment of the principal should be made. Convertible bonds are initially considered debt, but may turn into equity at a later stage. When the bondholder exercises the option, this does not result in a cash payment since the bond is exchanged for shares of the issuing company.

A variety of convertible instruments exists. At a basic level, a distinction is made between optional convertibles,[11] reverse convertibles, mandatory convertibles and contingent convertibles (CoCos).[12]

Certain exotic convertibles have also emerged, including "LYONs" and "toxic convertibles". The latter give the holder a right to shares at a fixed price. Any decrease in value of the issuing company will, accordingly, only affect existing shareholders but not the convertible bondholders. "Exchangeable bonds" resemble traditional convertible bonds, but with the important difference that the

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1. *See*, in general, B.S. Eswar, *Hybrid Instruments: Advantages and Disadvantages*, in *Handbook of Hybrid Instruments: Convertible Bonds, Preferred Shares, Lyons, ELKS, DECS and other Mandatory Convertible Notes* (I. Nelken ed., Wiley 2010); R. Brealey, S. Myers & F. Allen, *Principles of Corporate Finance* (12th ed., Mcgraw-Hill 2014); and M. Møller & N. Nielsen, *Konvertible obligationer i Danmark – Konstruktion, skat og prisdannelse*, Nationaløkonomisk Tidsskrift 134 (1996).
2. *See* T.A. Coxe, *Convertible Structures: Evolution Continues* in Nelken ed., *supra* n. 1, at 15.
3. *See* P. Vernimmen, *Corporate Finance – Theory and Practice* p. 583 (4th ed., Wiley 2014), who documents an increased use over the past 25 years.
4. *See* Eswar, *supra* n. 1, at 9.
5. *See* Eswar, *supra* n. 1, at 1 et seq.; C. Amby, *Beskatning af konvertible obligationer*, SR.2011.0301, p. 301 and T. Buur, *Konvertibel obligationer*, TfS, p. 80 (2011). The hybridity lies in the possibility to convert.
6. *See* Brealey, Meyers & Allen, *supra* n. 1, at 680 et seq.; J. Tirole, *The Theory of Corporate Finance* p. 77 (Princeton University Press 2006); S. Ross et al., *Modern Financial Management* (McGraw Hill 2008); *Vernimmen*, *supra* n. 3, at 582 et seq.; R. Pike & B. Neale, *Corporate Finance Investment Decision and Strategies* p. 283 (Financial Times Management 1993); F. Fabozzi et al., *Foundations of Financial Markets and Institutions* p. 426 and pp. 541-546 (Prentice Hall 1994); and A. Laukkanen, *Taxation of Investment Derivatives* (IBFD 2007), Online Books IBFD.
7. *See* B. Coyle, *Debt and Equity Markets – Hybrid Financial Instruments* p. 8 (Global Professional Publishing 2002).
8. *See* Eswar, *supra* n. 1, at 2; Brealey, Meyers & Allen, *supra* n. 1, at 680; *Vernimmen*, *supra* n. 3, at 582; and Møller & Nielsen, *supra* n. 1, at 25.
9. *See* J. Strnad, *Taxing Convertible Debt*, John M. Online Program in Law and Economics Working Paper No. 236, p. 2 (Mar. 2002).
10. Laukkanen, *supra* n. 6, at 44.
11. Coyle, *supra* n. 7, at 22 et seq., divides convertible instruments into six broad categories: conventional convertibles, low-premium convertibles, discount convertibles, rolling-premium put convertibles, single -premium put convertibles and liquid-yield option notes (zero-coupon convertibles).
12. *See* D. Trier et al., *The Taxation of Convertibles after Revenue Ruling 2002*, Tax Forum No. 734 Practicing Law Institute/Tax, p. 203 (2006).

conversion right will give the holder a right to convert its interest into shares of a company other than the issuing company. A "ratchet convertible" is a specific form of instrument that makes the conversion ratio dependent on the performance of the issuing company.

Typical terms and conditions of optional convertibles are as follows:[13]

– *Interest:* Convertible bonds typically carry a lower interest rate than plain vanilla bonds. This may be beneficial to growth companies with massive capital expenditures.[14] The lower interest rate reflects the conversion right of the holder. Convertible bonds can be issued along with a term stating that the interest will be increased at a future date if the bonds have not been converted (convertible debt with enhanced interest).[15]

– *Term:* As with other types of loans, the duration of financing varies significantly, ranging from short-term loans to perpetual convertible debt. Normally, convertible bonds are issued with a fixed maturity/repayment date.[16] Repayment must take place at par value at the fixed date. In practice, repayment often takes place prior to maturity, for example, due to the exercise of a call option for the issuer to repay or a put option, allowing the investor to demand repayment.[17]

– *Conversion right:* Convertible bonds present a right of the holder to convert the bonds to equity under certain conditions.[18] The conversion right must be exercised: (1) at a fixed date; (2) at either one of several fixed conversion dates; or (3) during a conversion period. Convertibles are normally converted into a fixed number of shares. The "conversion ratio" (which may vary from year to year) expresses the number of shares that the bonds can be converted into.[19] The "conversion price" is the price of the shares that the bonds can be converted to and is typically fixed at the time of issuance. When convertible bonds are issued, the conversion price is higher than the actual market price of the shares at the time. The difference in price between the convertible bonds and the shares that they can be converted into is called the "conversion premium". From an investor perspective, one attractive feature is the possibility that the share price will increase and eventually exceed the conversion price.[20]

– *Ratchet convertible:* HFIs serve a purpose for investors (for example, venture capital funds) in risky businesses.[21] People considering investing in start-ups or other risky companies face the challenges of illiquidity and information shortfall. To alleviate these difficulties, venture capitalists have created what can be viewed as innovative HFIs. In respect of convertible bonds, some of these problems might be resolved by making the conversion ratio dependent on the performance of the company.[22] Referred to as a "ratchet" convertible, a feature of this type of security is an option that converts into a declining ratio of company shares as the rate of return on the investment exceeds a certain ceiling. Conversely, the option might convert into an even greater number of shares as the investor's rate of return falls below a given floor. Compared to the return on a convertible note with a fixed rate of conversion, the return on a ratchet convertible is less exposed to the fortunes of the company: it pays more than a fixed-rate convertible in respect of a less successful company but less than a fixed-rate convertible in respect of a company that is very successful. The entrepreneur is given an ever-increasing upside incentive; a venture capital investor is given downside protection.[23] This is an example of how a difficult problem of conflicting interests between parties aggravated by imperfect information can be addressed by using HFIs.[24]

– *Call option for the issuer:* Convertible bonds are often seen to include a call option for the issuer to redeem the bonds at a certain premium.[25] Such an option is, however, subject to "call protection", which prevents the holder from exercising the option for a certain period. In the event the option is exercised, the investors might choose whether to hand over their bonds or to convert. An exercise of a call option can thus force a conversion if the share price is sufficiently high.

2.2. Mandatory convertibles and reverse convertibles

Certain convertible instruments include terms that provide for mandatory or very likely conversion into equity. Such instruments are referred to as "mandatory convertibles"[26] and may be described as follows:

> […] in their most basic form, an issuer will issue a debt security or preferred stock that is mandatorily convertible within a specified number of years in to the issuer's own common stock […][27]

13. *See*, for example, Strnad, *supra* n. 9, at 20 et seq., who outlines "stylized facts" on convertible bonds. *See* moreover C. Lewis & P. Verwijmeren, *Convertible Security Design and Contract Innovation*, 17 J. of Corporate Fin. 4 (2011).
14. *See* Coyle, *supra* n. 7, at 8; Laukkanen, *supra* n. 6, at 44; and Eswar, *supra* n. 1, at 3.
15. Coyle, *supra* n. 7, at 32.
16. Id., at 9.
17. Id.
18. Id., at 11.
19. Id.
20. Id., at 16.
21. *See* G. Longhouse, *Making the Line a Gap: Edgar's Treatment of the Debt-Equity Boundary*, 50 J. of Cdn. Tax Law 1, p. 242 (2002).
22. Id., at 243.
23. Id.
24. The example is used by Longhouse, id., to demonstrate that there is more to the market than arbitrage.
25. *See* Strnad, *supra* n. 9, at 10; Ross et al., *supra* n. 6, at 708; Vernimmen, *supra* n. 3, at 584; Coyle, *supra* n. 7, at 19 et seq.; and Laukkanen, *supra* n. 6, at 44.
26. Vernimmen, *supra* n. 3, at 592; Laukkanen, *supra* n. 6, at 48; K. Pajak, *Mandatory Convertible Bonds as Special Hybrid Financing Instruments*, Diplomarbeit (University of Vienna 2008); and T. Marshall, *Will Mandatories Catch on in Europe?*, 34 Euromoney 405, p. 8 (Jan. 2003).
27. *See* C.J. Johnson & J. McLaughlin, Corporate Finance and the Securities Laws p. 750 (2nd ed., Aspen Law & Business 1997).

Moreover:

> Unlike the buyer of traditional convertible securities, who in effect purchases a call option on the underlying common stock, the buyer of mandatorily convertible securities is in effect selling a put option to the issuer […].[28]

Such instruments are often considered to be closer to equity than debt since repayment will be in the form of shares and since the "downside protection" is minimal and might be limited to the ongoing interest payment (if any). In addition, mandatory convertibles are, in many instances, treated as equity for accounting and rating agency purposes.[29]

A known variation is the "reverse convertible", which grants the issuer a conversion right rather than the holder and allows the investor choices with regard to repayment.[30] The distinct feature of reverse convertibles is described as follows:[31]

> […] under the contract the issuer, at maturity, has the choice of either repaying, in cash the holder the face value of the bond or transferring to the latter a certain number of shares of a specified third party corporation […]

Such terms are particularly variable for the issuer, if, for example, the share price were to drop significantly, resulting in a possibility to repay the debt with cheap stock. In this manner, the debt could be reduced in situations in which "financial distress" looms on the horizon.[32] Several variations of reverse convertibles exist, including a provision allowing the holder to convert into shares of a group company, a portfolio company of the issuer, or even a completely unrelated company.

There are three general characteristics of mandatory convertibles:
(1) mandatory conversion upon the maturity of the convertible;
(2) capped or limited appreciation potential compared to the underlying stock; and
(3) the dividend yield on a mandatory convertible is typically higher than on the underlying stock.[33]

Mandatory convertibles are more widespread in the United States than in Europe, but even the European market is expected to increase.[34] In recent years, a certain development with regard to mandatory convertibles has been the emergence of exotic instruments, such as Preferred Equity Redemption Cumulative Stock (PERCS),[35] Debt Exchangeable for Common Stock, Dividend Enhanced Convertible Securities (DECS)[36] and Preferred Redeemable Increased Dividend Equity Securities (PRIDES). Mandatory convertibles are also used in private transactions. Commonly used instruments include Convertible Preferred Equity Certificates (CPECs)[37] and Obligations Reimbursable in Action (ORAs), as seen under French law (*Obligations Remboursables en Action*).[38]

The rationale underlying the issuance of mandatory convertibles has only been minimally analysed in the economic theory.[39] A possible description of the reason for companies to engage in the issuance of mandatory convertibles is as follows:[40]

28. Id., at 761.
29. Vernimmen, *supra* n. 3, at 592 and Johnson & McLaughlin, *supra* n. 27, at 750.
30. *See* Laukkanen, *supra* n. 6, at 47 et seq. 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 (2000), Journals IBFD. That the definition is not fixed is clearly seen in the contribution by M.J. Feder, *Tax Treatment of Debt Instruments Without Fixed Right to Redemption*, 3 Derivs. & Fin. Instrums. 4, p. 230 (2001), Journals IBFD.
31. *See* Rotondaro, *supra* n. 30, at 258 et seq.
32. *See* Brealey, Meyers & Allen, *supra* n. 1, at 685; Vernimmen, *supra* n. 3 at 595; and Laukkanen, *supra* n. 6, at 47.
33. *See* T. Chemmanur, D. Nandy & A. Yan, *Why Issue Mandatory Convertibles? Theory and Empirical Evidence*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=417601 (accessed 14 Mar. 2006).
34. Vernimmen, *supra* n. 3, at 593, who points out that the instruments "[…] appeal to investors looking for high yield and capital appreciation, although they have less downside protection than standard convertible bonds. As a result we see interest from equity funds and outright investors but the main investors are hedge funds because they are able to significantly offset stock exposure […]".
35. Offered by Morgan Stanley.
36. Offered by Salomon Brothers.
37. *See*, in general, *Present Law and Background Relating to Tax Treatment of Business Debt – A Report to the Joint Committee on Taxation* p. 85 (July 2011) and M. Herzfeld, *Hybrid Mismatch Rules: Shaking Up Basic Tax Concepts*, 74 Tax Notes Intl. (28 Apr. 2014). The instruments vary in their design and are typically based on detailed contractual documentation. The following features are common: The CPEC is interest bearing (market interest rate). The interest will only be paid out in so far as the management of the issuing company decides to do so and if the company will not be insolvent as a consequence. CPECs are non-terminable, unless the issuing company is liquidated. CPECs have priority over share capital, but are subordinated to all other debt. The principal of the CPEC can only be repaid if the issuing company does not become insolvent as a consequence. After a certain period of, for example, 30 years, the issuer has a right to convert the CPEC into shares. The investor can only exercise the right to convert if the loan is in default and if the issuer does not want to repay the principal, including interest rolled into the principal. The issuer can also decide to call a conversion into shares. If the issuer has obtained a gain or received dividends from other companies, this will trigger a repayment, unless the issuer decided to convert into share capital. In the event of the latter, the CPEC will be repaid based on the highest amount of the nominal amount of the CPEC, including interest payments rolled into the principal, or a computed value of the loan based on the net asset value of the company as if the loan constituted part of the company's equity.
38. The instruments vary in their design and are typically based on detailed contractual documentation. An ORA is typically defined as a bond that must be settled with shares in the issuing company. An essential feature of an ORA is mandatory conversion, pursuant to which the ORA-holder cannot require repayment in any other way. If the ORA-holder does not carry out the share subscription by the planned capital increase, this will trigger an obligation to pay a contribution to the issuing company corresponding to the amount that has not been transferred to the ORA-issuer according to the agreement. The ORA-holder can demand settlement at any time. The ORA-issuer is obliged to secure a capital increase corresponding to the total ORAs. An ORA carries the right to interest payments and typically has a stated term of seven to ten years. Moreover, the ORA-holder will have significant rights in respect of the issuing company, ensuring that the company does not carry out different transactions without preserving shareholder rights for the ORA-holder, including capital increases, distributions, issuance of new bonds, as well as any merger involving dividends. ORA-holders are treated as shareholders in the event of a capital decrease. Under Danish law, ORAs were classified in TfS 2003.895 LR. The Tax Assessment Council stated that ORAs should not be considered share capital for Danish tax law purposes.
39. A thorough attempt has been made in Chemmanur, Nandy & Yan, *supra* n. 33. *See also* E.R. Arzac, *PERCS, DECS, and other Mandatory Convertibles*, 10 J. of Applied Corporate Finance 1, pp. 54-63 (1997) and E.R. Arzac, *PERCS, DECS and other Mandatory Convertibles*, in *The New Corporate Finance: Where Theory Meets Practice* (D. Chew ed., McGraw-Hill College 1999).
40. Chemmanur, Nandy & Yan, *supra* n. 33 at 35.

> […] we find that it is indeed firms facing a smaller extent of information asymmetry but a larger probability of financial distress that issue mandatory convertibles: those facing a larger extent of information asymmetry and a smaller probability of financial distress issue ordinary convertibles […].

Mandatory convertibles have also been described as a way to obtain "Back-Door Equity Financing",[41] which, since the 1980s, has provided highly leveraged or financially exposed companies with a possibility to obtain equity (Tier 1 capital).[42] Mandatory convertibles can, on the one hand, minimize the negative information consequences attributed to the issuance of equity instruments where information is asymmetrical. On the other hand, the issuer will guarantee the investor a yield that exceeds what would normally be expected in respect of dividends.[43]

2.3. Contingent convertible instruments

One specific form of additional Tier 1 capital is CoCos.[44] CoCos are debt instruments typically issued by banks or other regulated financial institutions that contain certain characteristics to optimize the capital adequacy position and are typically listed on an official stock exchange.[45] Contingent capital acts as equity and provides a cushion to convince depositors and other creditors that their money is safe.[46] Essentially, the term contingent capital is used very generally to describe a kind of put option enabling the issuer to issue new equity at pre-negotiated terms.

CoCos are typically perpetual. Repayment is at the discretion of the issuer and optional. The issuer undertakes to repay the bonds after thirty years, provided its core capital is sufficient at that moment and subject to the consent of the regulator. The issuer also undertakes, on a best-efforts basis, to raise new replacement capital if, on such date, its existing core capital is insufficient. The interest is at a fixed rate or a floating rate plus margin. Moreover, payment of interest is at the full discretion of the issuer. If interest is not paid, no dividend may be paid by the issuer until the next interest payment date ("dividend stopper"). Interest will not be paid and will be cancelled if, on the interest payment date, the distributable reserves of the issuer are insufficient. CoCos are direct, unsecured and subordinated debt obligations. The conversion feature implies that mandatory (automatic) conversion takes place upon the occurrence of a conversion trigger. As such, CoCos are, in fact, mandatory convertibles. Another possibility is for conversion to be at the option of the issuer. Conversion triggers typically relate to the issuer's capital ratio falling or threatening to fall below a certain threshold.[47] Triggers could be based on national financial criteria, as well as on an individual institution's condition. There is no conversion at the option of the bond issuer.

2.4. Warrant loans and option loans (*Bond cum Warrant*)

It is common to add warrants to debt or to package the sale of bonds with stock as a sweetener. Such packages are often referred to as warrant loans, warrant bond loans or option loans. They are a combination of a "straight bond" and a separate warrant[48] making them equity-like debt instruments. Warrant loans are internationally considered among the best-known HFIs.[49]

The remuneration for a warrant can be paid in two ways:

(1) An open agio (defined as the difference between the higher issuing value and the lower redemption value of the debenture bond) is granted by the creditor, while the nominal interest payments are in line with the conditions of the capital market.

(2) A hidden agio (which consists of lower interest rates compared to the rates on the capital market) is granted by the creditor, while the issuance and redemption value are equal to the par or nominal value.[50]

There is a close resemblance to convertible bonds and the two types of financial instruments seem to be considered close substitutes. The economic literature bears witness to this by dealing with the instruments as one and the same.[51] Occasionally, convertible bonds have been issued during periods when warrant bonds could not be issued by companies.[52] It is fair to assume that the economic reasoning underlying the issuance of warrant loans, to a great

41. E.R. Arzac, *Back-Door Equity Financing: Citigroup's $7.5 billion Mandatory Convertible Issue*, Colombia University (10 July 2008).
42. Id., at 2.
43. Id., at 6.
44. The background may be the issuance of a notice from the Basel Committee of 13 Jan. 2011, setting out requirements for banking institutions to follow. *See* Basel Committee, *Minimum requirements to ensure loss absorbency at the point of non-viability*. In the notice, they directed that all non-common Tier 1 and Tier 2 instruments must provide that, at the option of the local banking authority, the instrument will be written off or converted into common equity in the event the local banking authority determines the bank would otherwise become "non-viable." According to V. Hammer, S. Chen & P. Carman, *United States – Tax Treatment of Contingent Convertible Bonds*, 13 Derivs. & Fin. Instrums. 3, p. 97 (2011), Journals IBFD, CoCos are the instruments issued to date that are closest to satisfy this provision. *See also* C.W. Calomiris & R. Herring, *Why and How to Design a Contingent Convertible Debt Requirement* (2011), abstract available at http://ssrn.com/abstract=1815406 and M. Zähres, *Contingent Convertibles – Bank Bonds take on a new look*, Deutsche Bank Research (23 May 2011); Z. Eiger et al., *Hybrid Securities: An Overview, Practical Law, Multi-Jurisdictional Guide 2015/16*; and M. Krause, *Basel III: The Regulatory Framework*, 14 Derivs. & Fin. Instrums. 1, p. 16 (2012), Journals IBFD.
45. *See Introduction to the Comparative Survey*, 13 Derivs. & Fin. Instrums. 3, p. 96 (2011), Journals IBFD. The following generalized description of CoCo features is based on this introduction. Several financial institutions have issued their own versions of CoCos, including Lloyds Banking Group, Rabobank and Credit Suisse; *see* Hammer, Chen & Carman, *supra* n. 44., at 97. *See* Green et al., *Hybrid Securities: An Overview*, PLC, Capital Markets Multi-jurisdictional Guide 2012/13 , which provides an overview of the specific features of a number of specific issues.
46. Eiger et al., *supra* n. 44, at 6 et seq.
47. *See also* Hammer, Chen & Carman, *supra* n. 44.
48. *See* N. Rahim, A. Goodacre & C. Veld, *Wealth Effects of Convertible Bonds and Warrant-bond Loans: A Meta Analysis*, WP, p. 3 (2011), available at http://ssrn.com/abstract=1687098 and Laukkanen, *supra* n. 6, at 46.
49. *See*, for example, M. Theisen & M. Wenz, *Tax Treatment of Financial Instruments* (Michielse ed., Kluwer 1996), for a general description of German law.
50. Id.
51. *See*, for example, F. de Roon & C. Veld, *Announcement Effects of Convertible Bonds Loans and Warrant-bond Loans: An Empirical Analysis for the Dutch Market*, 22 J. of Banking & Finance 12 (Dec. 1998) and Rahim, Goodacre & Veld, *supra* n. 48.
52. Amby, *supra* n. 5, at 301.

extent, resembles the rationale behind the issuance of convertible bonds.

The use of warrant loans or option loans gives rise to several tax considerations, for example, whether to treat warrant loans as one or more instruments and questions regarding valuation and possible allocation of the acquisition price.

3. Domestic Tax Treatment of Optional Convertible Debt Instruments

3.1. Comparative overview

Convertible bonds have given rise to tax law challenges in many countries.[53] It is widespread practice to favour a debt classification of convertible bonds until conversion.[54] This also indicates that the mere right to convert debt into equity does not, in most jurisdictions, lead to a reclassification into equity, albeit the conversion right in some countries is considered a characteristic that is taken into account in the debt-equity classification.[55] Consequently, other equity traits might lead to equity classification for domestic tax purposes. In fact, as stated by Helminen (2010), the higher the probability of conversion, the greater the likelihood of reclassification as equity.[56] Moreover, the classification of convertible bonds also depends very much on whether the country in question applies an integration approach or a bifurcation approach.

With regard to Norwegian law, it has been widely debated whether convertible bonds should be treated as a single instrument or in accordance with a bifurcation approach. The question was settled by the Supreme Court decision in *Industrinvesteringer AS and Hafslund Venture AS* (8 December 2011), wherein the Court decided that convertible bonds should be treated as a single instrument (a bond) until conversion.[57] Based on this, taxpayers could not obtain the tax exemption for the warrant part of the convertible instruments in question.[58]

Under Swedish law, convertible bonds are generally treated as shares (*delägerrätter*).[59] If the convertible bonds are issued in a foreign currency, they are treated as debt.[60] Subscription of convertible bonds does not trigger any tax consequences.[61] Interest payments paid according to the convertible bonds are taxed as any other taxable interest income. Any gain or loss realized upon a sale of the convertible bond is taxable according to generally applicable principles on the computation of capital gains.[62] The conversion of convertible bonds is not considered a taxable event.[63]

Finnish law has adopted a bifurcation approach whereby convertible bonds are divided into a current earnings part and a capital gains part.[64]

Under Netherlands law, convertible debt is traditionally considered debt until conversion.[65] The fixed interest, therefore, constitutes a business expense for the issuer. Under Netherlands law, the *Hoge Raad* has ruled that convertible bonds denote a legal relationship for the holder against the issuing company, which is very similar to that of a shareholder.[66] Accordingly, the *Hoge Raad* found that the Netherlands participation exemption applies to a holder of convertible bonds. This implies that the benefit for a parent company arising from the conversion of a convertible loan issued by a subsidiary should be classified as a benefit derived from (future) share ownership. In the Netherlands commentary, this concept of future share ownership has been found to be new.[67]

53. *See* Laukkanen, *supra* n. 6, at 320 for an overview of the taxation of convertible bonds in the United States, United Kingdom, Germany, Finland and Sweden. A comparative survey on overall issues regarding hybrids, including convertibles, was published in 1 Derivs. & Fin. Instrums. 3, 4, 5, 6 (1999), Journals IBFD. French law is described in R. Renard & O. Rouch, *Taxation of Hybrid Instruments: France*, 1 Derivs. & Fin. Instrums. 5 (1999), Journals IBFD; German law in S. Trapp, *Taxation of Hybrid Instruments: Germany*, 1 Derivs. & Fin. Instrums. 6 (1999), Journals IBFD; Spanish law in E. Ramirez & F. Carreno, *Taxation of Hybrid Instruments: Spain*, 1 Derivs. & Fin. Instrums. 5 (1999), Journals IBFD; Netherlands law in A. Groot & A. Van der Linde, *Taxation of Hybrid Instruments: Netherlands*, 3 Derivs. & Fin. Instrums. 1 (2001), Journals IBFD; Australian law in N. Orow, *Tax Treatment of Debt Instruments without Fixed Right to Redemption: Australia*, 3 Derivs. & Fin. Instrums. 4, p. 214 (2001), Journals IBFD; and Belgian law in H. Lamon, F. Weynants & D. Berckmans, *Tax Treatment of Debt Instruments without Fixed Right to Redemption: Belgium*, 3 Derivs. & Fin. Instrums. 3, p. 155 (2001), Journals IBFD. *See* R. Obermann, *Tax Relief on Interest on German Convertible Bonds, Zinsen aus deutschen Wandelanleihen – Wege und Irrwege aus der Doppelbesteuerung*, SWI 1 (2012) regarding the Austrian consequences of German convertible bonds. A multi-jurisdictional overview is provided in Freshfields Bruckhaus Deringer, *Convertible Bonds – A Multijurisdictional Tax Survey* (2009). This overview also contains information regarding mandatory convertibles.
54. *See*, as illustrative, T. Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, p. 52 (Canadian Tax Foundation 2000) and M. Helminen, *The International Tax Law Concept of Dividend*, vol. 36, p. 192 (Wolters Kluwer Law & Business 2010). A similar result is reported by Freshfields Bruckhaus Deringer, *supra* n. 53, with respect to Austria, Belgium, France, Germany, the Netherlands, Spain and the United States (with a caveat regarding mandatory convertibles, which may be classified as equity). A bifurcation approach is reported in the United Kingdom, Germany and Austria.
55. *See* Helminen, id., at 192.
56. Id.
57. *See* NO: HR, 8 Dec. 2011, HR-2011-02285-A (Sak no. 2011/869), *Industrinvesteringer AS and Hafslund Venture AS*.
58. *See*, for commentary prior to the final decision, H. Matre, *Studier i det skatterettslige rentefradraget – med særlig sikte på hybridfinansiering av aksjeselskaber* (University of Bergen 2010). Matre suggests that convertible bonds should be considered equity instruments if the warrant element of the convertible instrument makes up most of the total value of the instrument.
59. *See*, to this effect, M. Dahlberg, *Ränta eller kapitalvinst – Grundproblem I kapitalinkomstbeskattningen – särskilt vad gäller finansiella instrument I gränslandet mellan lånekapital och eget capital*, p. 575 (Iustus 2011); Laukkanen, *supra* n. 6, at 334 et seq. with references, and Helminen, *supra* n. 54, at 299 et seq.
60. *See* Dahlberg, *supra* n. 59, at 576, who argues in favour of clearer legislation in the area.
61. Id., at 577.
62. Id., at 586.
63. Id., at 591.
64. *See* Laukkanen, *supra* n. 6, at 330.
65. *See*, for Netherlands law, Michielse, *supra* n. 49, at 248 et seq.; E. Jansen & E. van Kasteren, *Hybrid Financial Instruments*, 10 Derivs. & Fin. Instrums. 5, p. 180 et seq. (2008), Journals IBFD; and R. Kok, *The Classification of Debt and Equity*, 16 Derivs. & Fin. Instrums. 4, p. 204 (2014), Journals IBFD.
66. *See* NL: HR, 12 Oct. 2007, Case No. 43.643. The case is analysed in detail in E. de Gunst & J.W. Rompen, *Supreme Court Ruling on Taxation of Convertibles and Application of Participation Exemption: A Discussion of the Case and Its Broader Meaning*, 10 Derivs. & Fin. Instrums. 1 (2008), Journals IBFD.
67. *See* de Gunst & Rompen, id., at 6.

The United Kingdom applies a bifurcation approach to qualified hybrid instruments, splitting such instruments into the host contract and the embedded derivative.[68] The bond of the instrument is treated according to the specific UK loan relationship regime, whereas the embedded derivative (the call option), falls within the derivative contract regime.[69]

3.2. US federal tax law

The traditional debt/equity classification issue under US federal tax law also applies to convertible bonds.[70] Convertible debt is normally treated as a "single property" in the form of debt until conversion.[71] After conversion, the instrument becomes equity. Convertible bonds are not governed by any particular Code provision, which means the appropriate tax treatment of convertible instruments under US law depends on various Code provisions, Treasury Regulations, judicial decisions and IRS pronouncements.[72] In terms of classification, convertibility alone does not lead to equity classification, but is merely a factor that is included in the general debt/equity test. As stated in IRS Notice 94-47, convertible debt, which includes terms that require the holder to convert the debt into shares, may be treated as equity for tax purposes.

Participation in the success of a corporation is clearly an equity feature and, as such, is essential to equity status, but not necessarily inconsistent with a creditor-debtor relationship.[73] This holds true if the participation takes the form of a right to receive a portion of the debtor's above-target earnings or an option to convert debt into equity, as seen with convertible bonds.[74] Traditional convertible instruments substantially feature equity characteristics, but only on the upside. Because the holder has the right to demand payment of the principal at maturity, these notes generally have been respected as debt. If an instrument is convertible, it is more likely to be classified as equity. The conversion option might be explicit in the instrument's terms or might be implied when the corporate issuer has the discretion to repay a debt instrument through use of its own stock. The IRS has ruled, however, that a convertible instrument that promises the holder only 60% of its initial investment, and is not converted, is equity because this feature was calculated primarily to ensure conversion into stock.[75]

If, however, the exercise of a conversion right is virtually certain, for example, because of specified ratios (mandatory convertibles), the debt features of the instrument might be brushed aside as camouflage.[76] A convertible bond differs from a bond with a warrant in that, inter alia, whereas exercise of the warrant brings in new cash, but leaves the corporation indebted on the bond, conversion extinguishes the bond indebtedness.[77] It, however, confers none of the attributes of immediate stock ownership and does not impose an equity-like risk on the holder.

Convertible bonds are non-severable from a financial point of view, since the holder must forfeit his creditor position if he wishes to become a shareholder.[78]

For US federal tax purposes, a conversion of convertible bonds has been treated as a non-taxable event.[79] This has been well established since 1920.[80] The conventional theory is that a gain or loss is not realized upon the conversion.[81]

The rather complicated technical rules regarding convertible bonds are analysed in the tax literature.[82]

3.3. German tax law

Convertible bonds are commonly used in the German market (*Wandelanleihen*).[83] The tax treatment of convertible instruments follows the accounting treatment and there is no specific provision regarding the issuance of convertible bonds.[84]

Prior to the conversion, convertible bonds are classified as debt for tax purposes.[85] As a consequence of this classification, the convertible bond produces interest income, which is taxable in the hands of the holder and deductible for the issuer.[86] The same applies to option and warrant loans. Income and expenses have to be allocated over the lifetime of the bonds. Both convertible bonds and option

68. *See* Laukkanen, *supra* n. 6, at 326.
69. Id.
70. If the instrument is reclassified as equity, the usual characteristics of equity apply, including the non-deductibility of the interest payments; *see* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, p. 4-115 (Warren Gorham & Lamont 2000).
71. *See* Bittker & Eustice, id., at 4-115 et seq.; Helminen, *supra* n. 54, at 298. *See* D. Schneider et al., *Equity Classification of Convertible Debt?: Tax and Cash Flow Considerations*, 11 J. of Applied Business Research 4 (1995), regarding the possible effects of a change in the IRS and US GAAP treatment of convertible debt.
72. *See* Laukkanen, *supra* n. 6, at 320.
73. *See* Bittker & Eustice, *supra* n. 70, at 4-28; Hammer, Chen & Carman, *supra* n. 44., at 338, D. Garlock, Federal Income Taxation of Debt Instruments, sec. 1017 (Prentice Hall & Business 2007). The IRS has stated that the presence of a sum certain payable at maturity is a sine qua non of debt treatment under the IRC; *see* FSA 199940007 and Notice 94-47, *supra* n. 73.
74. *See* Bittker & Eustice, *supra* n. 70, at 4-28, L. Burilovich, *Planning Techniques to Avoid the Reclassification of Shareholder Debt as Equity*, The Tax Adviser, p. 3 (1 Dec. 2006).
75. *See* Rev. Rul. 83-98, 1983-2 C.B. 40, 41.
76. *See* Rev. Rul. 83-98 and Bittker & Eustice, *supra* n. 70, at 4-29.
77. *See* W. Plumb, *The Federal Income Tax Significance of Corporate Debt. A Critical Analysis and a Proposal*, 26 Tax Law Rev. 3, p. 435 (1971).
78. *See* Bittker & Eustice, *supra* n. 70.
79. *See* Bittker & Eustice, *supra* n. 70, at 4-120 and Garlock, *supra* n. 73, at sec. 10,009.
80. Bittker & Eustice, *supra* n. 70, at 4-121.
81. Id., at 4-120.
82. *See* Trier et al., *supra* n. 12. It is stated that, over the years, a number of more esoteric variations of convertibles have been issued, reflecting both the particular financial conditions at the time and the remarkable ingenuity of investment banker. *See also* Strnad, *supra* n. 9 and New York Bar Association Tax Section, *Report on the Taxation of Straight and Contingent Convertible Debt*, Report no. 1022 (2002).
83. *See* Theisen, *supra* n. 49, at 185 et seq.; and Laukkanen, *supra* n. 6, at 328.
84. *See* Trapp, *supra* n. 53, at 323 and M. Häger & M. Muller, *Mezzanine Finanzierungsinstrumente* (Häger & Elkemann-Reusch eds., Erich Schmidt Verlag 2007).
85. *See* Trapp, *supra* n. 53, at 323; Theisen, *supra* n. 49, at 187, Helminen, *supra* n. 54, at 299; Freshfields Bruckhaus Deringer, *supra* n. 53, at 15 et seq. and S.E. Bärsch & T. Lakenberg, *Convertible Bonds and Preference Shares: New Corporate Law Environment and Resent Tax Developments*, 17 Derivs. & Fin. Instrums. 6 (2015), Journals IBFD.
86. *See* Theisen, *supra* n. 49, at 189 and Helminen, *supra* n. 54, at 299.

loans might be classified as equity if they also include other equity characteristics.[87]

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.[88]

The conversion of bonds to shares is a non-realization event and no tax consequences are realized for the investors.[89] For corporate holders, all current profits and capital gains deriving from the bond's purchase and sale or redemption are subject to tax as business profits.[90]

3.4. Danish tax law

The fact that convertible instruments vary significantly highlights the importance of considering the tax law requirements governing convertible bonds. This is especially true if the overall goal is to obtain neutrality. The task is complicated by the fact that certain instruments, albeit somewhat identical, serve different financial objectives. Accordingly, it is essential to assess the impact of the tax legislation on the issuance of convertible instruments, since such issuances can be largely driven by non-tax concerns, including the need to improve efficiency.[91]

Convertible bonds are governed by section 1(1) of the Danish Act on Taxation of Capital Gains on Sale of Shares (*Aktieavancebeskatningsloven*) and section 1(4) of the Capital Gains Tax Act (*Kursgevinstloven*).[92] Historically, convertible bonds have been treated as claims, warrants or as both leading to the current inclusion under the scope of the Danish Act on Taxation of Capital Gains on Sale of Shares.[93] The first time specific legislation was introduced into Danish tax law was in 1981.[94] Since then, it seems that the rules have been constantly changing. Danish law has never specifically regulated how convertible bonds in different scenarios should be taxed.

The following definition now applies under Danish tax law:[95] A convertible bond is defined as a bond issued by a public or private limited company giving the investor a right to convert the claim on the company into shares in the issuing company or to require repayment in cash. The conversion right applies for a fixed period of time. Finally, it is required that the conversion right reflect a right in substance.

If such a right is not part of the instrument in question, it will be treated merely as a claim subject to the Capital Gains Tax Act.[96] This definition is noteworthy. On the one hand, it is a definition and, on the other, it gives the impression that it is merely a description of typical terms in convertible bonds. The criteria were further developed in TfS 2009.67 SR, wherein the Danish tax authorities set forth that there must be: (1) a conversion right; (2) a right to claim repayment in cash; and (3) no obligation for the holder to convert. These criteria seem to fit into the existing company law and tax law nomenclature.

The above definition applies to convertibles issued by Danish, as well as foreign, companies. In terms of foreign companies, this could give rise to certain challenges when a convertible instrument issued in a foreign company contains terms that are not specifically included in the Danish definition (*see*, for example, SKM2008.962.SR).[97]

The article now turns to a description of the Danish tax treatment of an investor in convertible bonds,[98] followed by a description of the tax treatment of the issuer of convertible bonds.

The mere issuance of convertible bonds does not trigger any tax consequences for the issuing company or for the investor according to Danish tax law.

Repayment of a convertible bond is considered parallel to disposal of the instrument. Repayment can be made to the issuing company or a third party. The Danish Act on Taxation of Capital Gains on Sale of Shares is applicable if cash repayment takes place at the initially agreed repayment date and at the initially agreed repayment price.[99]

Convertible bonds are considered sold or repaid when the due date arises.[100] Repayment of a convertible bond at a premium or prior to the due date is also considered a sale of the convertible bond.[101] If, however, repayment takes place prior to the due date or at the due date but at an amount exceeding the agreed principal of the loan, this is considered a sale of the convertible bond to the issuing company subject to section 16 B of the Danish Tax Assessment Act (*Ligningsloven*), i.e. dividend treatment applies.[102]

The conversion, as such, does not trigger any Danish tax implications.[103] Conversion prior to the agreed exercise

87. Helminen, *supra* n. 54, at 299.
88. Theisen, *supra* n. 49, at 187.
89. *See* S. Briesemeister, *Hybride Finanzinstrumente im Ertragsteuerrecht* (IDW 2006) and Laukkanen, *supra* n. 6, at 329.
90. *See* Trapp, *supra* n. 53, at 323.
91. Strnad, *supra* n. 9, at 4.
92. Specific considerations are applicable to employees; *see* TfS 1988.286 LR and, for commentary, C. Led-Jensen, *Beskatning af lønindkomst – herunder aktiebaserede aflønningsformer* p. 260 (Jurist- og Økonomforbundets Forlag 2000).
93. *See*, with regard to the historical development, Led-Jensen, id., at 255 and N. Jakobsen, *Kommentarer til udvalgte afgørelser, Anderkendelse af lån i skatteretlig henseende*, R&R 7, p. 194 (2000). *See*, in general, for an overview of the taxation of convertible bonds, Betænkning no. 856 (1978); E. Banner-Voigt et al., *Aktieavancebeskatning* (Karnov Group 2006); B. Ramskov, *Intern selskabsomstrukturering* (Djøf Forlag 2001); E. Christiansen, *Beskatning af aktionærer* (Magnus 1998); J. Berning, *Finansieringsret* (GAD 1977); L. Andersen, *Konvertible obligationer – en anden betragtning af den skattemæssige behandling*, SpO (1974); C. Amby, *skattemæssige regler for konvertible obligationer*, SR-Skat (1990); and Amby, *supra* n. 5, at 301 et seq.
94. *See* sec. 8 in the historical ABL, in particular, Act no. 295 of 10 June 1981.
95. *See* the preparatory remarks to Act no. 440 of 10 June 1997 (Bill no. L 195); Circular no. 137 of 19 July 1994, para. 11; preparatory remarks to Bill no. L 78 2005 re: sec. 1(3); and Juridisk Vejledning C.A.5.17.6.
96. Id.
97. *See also* Amby, *supra* n. 5, at 301 et seq.
98. The following assumes that the investor is subject to corporate income tax.
99. *See* Amby, *supra* n. 5, at 302 and Buur, *supra* n. 5.
100. *See* Led-Jensen, *supra* n. 92, at 271.
101. A recent case illustrating this is SKM2010.774.SR. *See* Banner-Voigt, *supra* n. 93, at 270 and Amby, *supra* n. 5, at 302.
102. *See* the preparatory remarks to Act no. 310 of 25 May 1987 and Bill no. L 195 (Act. no. 440 of 10 June 1997), p. 969 et seq.
103. *See*, for an early statement of this, FT 1985/86 A sp. 592. *See also* TfS 1990.333 T&S; Banner-Voigt, *supra* n. 93, at 269, Amby, *supra* n. 5, at 301 et seq., and Buur, *supra* n. 5.

date is not considered a disposal of the convertible bond. An economic benefit received by the conversion might, however, trigger tax consequences.[104] According to section 29 A of the Danish Act on Taxation of Capital Gains on Sale of Shares, the time of acquisition of shares acquired through a conversion of convertible bonds is set as the conversion date.

Any gain or loss on convertible bonds is treated according to section 1(3) of the Danish Act on Taxation of Capital Gains on Sale of Shares.[105] Shares received upon conversion may be classified as subsidiary shares or as group shares, which are tax exempt. Convertible bonds cannot, however, be classified as subsidiary shares or as group shares.[106] Convertible bonds held by corporate investors are per se considered taxable portfolio shares.[107] This is likely to include dividends paid as a consequence of premature repayment of a convertible bond, which are also considered taxable. Consequently, any gain on a convertible bond is taxable and losses are deductible.

All existing tax provisions under Danish tax law on the treatment of convertible bonds concern the treatment of investors owning the convertible bonds. The issuing company is not subject to these provisions.

The issuance of convertible bonds does not trigger any tax consequences for the issuing company or the investor. From the perspective of the issuer, the convertible bond is a loan and the subscription amount is considered loan proceeds. The issuer is treated in a similar manner as the issuer of shares, with the result that the issuer is not taxed on gains and is not allowed a deduction for any loss connected to the issuance, repayment or conversion of the convertible bond.

Convertible bonds might carry an interest payment, which can be designed in various ways. Interest payments are treated as other interest payments according to Danish tax law. Interest payments are deductible according to section 6e of the Danish Government Taxation Act (*Statsskatteloven*) in so far as the payment qualifies as an interest payment and is subject to the specific interest limitation provisions applicable under Danish law.

As a starting point, the freedom of contract applies to the design of financial instruments under Danish law. This does not mean, however, that there are no limits on the design of convertible bonds and the yield thereon, in terms of the characterization of interest and capital gains.

104. *See* TfS 1988.286 LR. In TfS 1990.333 LR, *supra* n. 103, and TfS 1990.334 LR, it was found that the conversion, as such, did not trigger any consequences but that the subscription of shares led to taxation if the subscription of shares was carried out at a premium.
105. *See also* Amby, *supra* n. 5, at 301 et seq., and Buur, *supra* n. 5.
106. *See* secs. 4 A(7) and 4 B(3) ABL.
107. *See* Amby, *supra* n. 5, at 303, who states that the background is the fact that convertible bonds are not covered by the EU Parent-Subsidiary Directive (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).